Credit rating agency liability in Europe: Rating the combination of EU and national law in rights of redress
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3 Credit rating industry and its regulation

3.1 Introductory remarks

The previous Chapter broadened the scope of the study to the European legal context in which Article 35a CRA Regulation can be considered. This Chapter zooms in on the credit rating industry and its regulation in particular. It forms the basis for the other parts of this dissertation, by providing relevant background information on the credit rating industry and its history, credit ratings, the EU regulatory framework for credit rating agencies and the factual side of credit rating agency liability. The information provided in this Chapter was deemed necessary due to the peculiar features of the credit rating industry and its effects on the discussion around credit rating agency liability.

The Chapter begins with describing the credit rating industry, its regulation and its civil liability from a historical perspective (section 3.2). The historical perspective serves to contribute to the understanding of the current features of the credit rating industry, the functions of credit ratings and the sequence of events leading to the currently established regulatory framework in the EU and the US. It demonstrates that the criticism of the credit rating industry and the debate on civil liability in the aftermath of the financial crisis was not new. On the contrary, since their establishment, credit rating agencies have been discredited at various points in time, which has led to debates on their regulation and their civil liability.[1] Section 3.3 concentrates on credit ratings, including a discussion of their functions and effects on the financial markets. Section 3.4 describes part of the EU regulatory framework established by the CRA Regulation, providing the broad regulatory picture in which Article 35a CRA Regulation can be understood.

Sections 3.5 and 3.6 serve as a prelude to Chapters 4 and 5, by concentrating on Article 35a CRA Regulation and by providing a factual perspective on credit rating agency liability. Section 3.5 describes the legislative history of Article 35a CRA Regulation and refers to the conditions for civil liability under Article 35a CRA Regulation.[2] Furthermore, it pays attention to the scope of application of Article 35a CRA Regulation by describing the stakeholders that

1 Horsch 2014, p. 232 on the 'crisis-driven' pattern of credit rating agency regulation since 2000.

2 Section 5.3 discusses the conditions for civil liability under Art. 35a CRA Regulation in detail in the context of the legal comparison.

could be involved in litigation based on Article 35a CRA Regulation (credit rating agencies, issuers and investors). Section 3.6 provides a factual perspective on credit rating agency liability, by describing various factual scenarios in which issuers and investors could suffer loss as a result of an incorrect credit rating.

3.2 Historical perspective credit rating industry and civil liability[3]

3.2.1 Origins: credit reporting agencies, financial press and the first credit rating agencies

The credit rating industry arose in the mid-19th century in the United States from a need for independent reviews of creditworthiness of American merchants. The importance of such independent information became clear after the outbreak of the 'Panic of 1837' – a financial crisis in the US starting in 1837. Prior to this financial crisis, American merchants used their personal connections to gather information on the creditworthiness of counterparties they did not know personally.[4] This method, however, proved to be ineffective when American merchants realised they should not have trusted part of their counterparties.[5] Credit reporting agencies such as the Mercantile Agency and the Bradstreet Agency responded to the need for independent credit information by gathering information on potential borrowers and summarising this information in credit reports.[6]

With the establishment of credit reporting agencies, debates on their liability and regulation arose as well. As from the 1840s, the credit reporting agencies were confronted with liability claims brought by parties who were reviewed by the reports and parties who relied on the reports.[7] The debate on the balance between defamation and freedom of speech already came up in early cases such as *Beardsley v Tappan* (proceedings started in 1951),[8] *Billings v Russell* (1855)[9] and *Ormsby v Douglass* (1868).[10] The credit reporting agencies invoked

3 *More extensive overviews are provided by e.g.* Simon 2017, pp. 38 ff., Horsch 2014, pp. 231 ff., Darbellay 2013, pp. 13 ff., Gaillard 2010, Coffee 2006, pp. 283 ff., Sylla 2001 and Madison 1974. As credit rating agencies originate from the US, the description of their history will mainly be situated in the US, but some attention will also be paid to the history of credit rating activities in the EU.

4 Madison 1974, pp. 165-166. *See also* Sylla 2001, p. 7.

5 Madison 1974, p. 166.

6 Madison 1974, pp. 166-168. *See also* Sylla 2001, pp. 7-8.

7 *For a detailed analysis see e.g.* Madison 1974, pp. 177 ff. and Lipartito 2013.

8 *Beardsley v Tappan*, 5 Blatchf. 498 (1867).

9 Supreme Judicial Court of Massachusetts, November 1855, *Boston Law Reporter* vol. 8, new series, pp. 699 ff. (*Billings v Russell*) as published by the Reports of the Four Leading Cases Against The Mercantile Agency for Libel and Slander, New York: Dun, Barlow & Co. 1873,

the defence of 'privileged communication' and argued that their credit reports should not be subject to the rules of libel and slander in claims brought by parties reviewed by the reports because they qualified as 'privileged communication' between the credit reporting agency and the party who made use of the reports.[11] Although the US courts did not accept an appeal to this defence in *Beardsley v Tappan*, the US courts did accept appeals to this defence in other subsequent cases.[12] By invoking this defence, credit reporting agencies often successfully defended themselves against liability claims brought by the parties who were reviewed in their credit reports. In these early days of the credit reporting industry, the US courts also decided that the inaccuracy of credit reports was not sufficient to establish the liability of credit reporting agencies towards the users of credit reports. Even though reports contained inaccurate information, the US courts rejected claims for liability when the credit reporting agencies had exercised reasonable diligence.[13] The first attempts to arrange for the civil liability of credit reporting agencies by statute date back to the 1870s, when the US states Missouri, Illinois, New York and Pennsylvania proposed bills to hold credit reporting agencies liable for loss 'suffered by businessmen as a result of inaccurate credit reports'.[14] However, none of the bills entered into force after strong opposition by the Dun Agency (the successor of the merged Mercantile Agency and the Bradstreet Agency).[15]

In addition to credit reporting agencies, the financial press also provided independent credit information.[16] Moody's, Standard & Poor's and Fitch initially started as publishers. Whereas Henry Varnum Poor gathered information on the US railroads and published the *Manual of the Railroads of the United*

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p. 132. The jury rejected the claim for damages because the claimant did not succeed in proving slander or libel.

10 Court of Appeals of the State of New York 1 January 1868, 37 N.Y. 477 (N.Y. 1868) (*Ormsby v Douglass*), 486.

11 *See* Madison 1974, pp. 177-178.

12 Madison 1974, p. 178, explaining the US courts changed their approach in Court of Appeals of the State of New York 1 January 1868, 37 N.Y. 477 (N.Y. 1868) (*Ormsby v Douglass*). *See on Ormsby v Douglass* Lipartito 2013, pp. 666 ff.

13 Madison 1974, p. 179.

14 Madison 1974, p. 180. Madison based his findings on the following sources: 'Journal of the House of Representatives of the States of Missouri, at the Adjourned Session of the Twenty-Seventh General Assembly, Commencing January 7, 1874 (Jefferson City, 1874), 145; Journal of the House of Representatives of the Commonwealth of Pennsylvania, for the Session Begun at Harrisburg, on the 6th Day of January, 1874 (Harrisburg, 1874), 397, 445; Journal of the House of Representatives of the Twenty-Eighth General Assembly of the State of Illinois, at the Adjourned Regular Session, Begun and Held at Springfield, January 6, 1874 (Springfield, 1874), 191, 196, 334, 489; Journal of the Senate of the State of New York: At their Ninety-Seventh Session Begun and Held at the Capitol in the City of Albany, on the Sixth Day of January, 1874 (Albany, 1874), 275, 288'.

15 Madison 1974, pp. 181-182.

16 *See* Sylla 2001, p. 8.

States (as from 1849),[17] John Moody published *Moody's Manual of Industrial and Miscellaneous Securities* (as from 1900)[18] and, in 1913, the Fitch Publishing Company was founded which published *The Fitch Stock and Bond Manual* and *The Fitch Bond Book*. In 1909, Moody's was the first modern credit rating agency to be established. Moody's began to translate the credit information into a single symbol (a credit rating).[19] Afterwards, the other publishers started to issue credit ratings as well: Poor's Publishing Company in 1916,[20] the Standard Statistics Company in 1922[21] (in 1941, Poor's Publishing Company merged with Standard Statistics and became Standard & Poor's) and Fitch in 1924.[22] During this period, Moody's and Standard & Poor's began to issue credit ratings attached to European companies, European financial instruments and states as well.[23] During this first period, credit rating agencies based their business model on subscriptions paid for by investors. The use of credit ratings increased and credit rating agencies built up their reputational capital, as investors realised they could save research costs by using credit ratings and could access the capital markets more easily.[24]

3.2.2 Expansion: regulatory purposes, issuer pays and structured finance

After a period of growth and success, the reputation of credit rating agencies deteriorated and the use of credit rating decreased subsequent to the beginning of the Great Depression in 1929.[25] Issuers defaulted and credit rating agencies had to downgrade many credit ratings below investment grade.[26] The credit rating industry ended up in a downwards spiral: research showed the inaccuracy and lack of timeliness of credit ratings,[27] credit rating agencies were losing their reputation so that investors were no longer relying on credit ratings and were no longer prepared to pay for them.[28]

17 Sylla 2001, pp. 8-9.
18 *See* www.moodys.com/Pages/atc001.aspx, last accessed at 31 August 2019.
19 *See* www.moodys.com/Pages/atc001.aspx, last accessed at 31 August 2019. *Also e.g.* Darbellay 2013, pp. 17-18 and White 2009, p. 1.
20 Sylla 2001, p. 9. *Also* White 2009, p. 1.
21 White 2009, p. 1.
22 Coffee 2006, p. 293. *Also* White 2009, p. 1.
23 *See* www.moodys.com/pages/default_em.aspx, last accessed at 31 August 2019 and Moody's Investors Service European Union Transparency Report 2014, p. 2, available at www.moodys.com/sites/products/ProductAttachments/SP33094_MIS_EU_TransparencyReport_2015.pdf, last accessed at 31 August 2019. *Cf. also* Bhatia 2002, p. 5. *In respect of sovereign ratings*, Gaillard 2010, p. 45.
24 Darbellay 2013, pp. 18-19.
25 *See* Darbellay 2013, p. 22.
26 Flandreau, Gaillard & Packer 2010, pp. 10-11.
27 *E.g.* a study conducted by Hempel, discussed by Sylla 2001, p. 20. Flandreau, Gaillard & Packer 2010 confirmed these research outcomes.
28 Darbellay 2013, p. 22.

Yet, during the same period, the US legislature started to make use of credit ratings in legislation.[29] As a consequence, credit ratings no longer only served informational functions, but also began to serve regulatory functions. In 1931, the Office of the Comptroller of the Currency encouraged banks to invest in bonds with an investment grade rating, by stating that bonds with a speculative grade rating would be 'written down to market value and 50 percent of the resulting book losses were to be charged against capital'.[30] Furthermore, under the US Banking Act of 1936, banks were prohibited from investing in bonds lacking an investment grade rating.[31] The US legislature in fact 'outsourced'[32] creditworthiness assessments to credit rating agencies, rather than developing its own methodologies.

In the 1970s, the US and the Union legislature and the Basel Committee intensified the regulatory function of credit ratings by incorporating credit ratings further in financial regulation.[33] Regulators used credit ratings, for instance, as a method to determine the amount of capital to be held by financial institutions.[34] In order to establish which credit ratings could be used for regulatory purposes, in 1975, the SEC introduced the 'NRSRO concept' (the Nationally Recognized Statistical Rating Organization concept).[35] Solely credit rating agencies with an NRSRO status could issue credit ratings that were allowed to be used for regulatory purposes. From this perspective, the legislatures empowered the credit rating industry and the large credit rating agencies of Moody's, Standard & Poor's and Fitch in particular.

As from the 1970s, the credit rating industry in both the United States and Europe went through a period of growth.[36] Having caused the financial markets to place more reliance on credit ratings, the increased regulatory use of credit ratings contributed to this growth. Also, credit rating agencies increased their revenues by changing from the 'subscription based model' to the 'issuer pays model'.[37] Whereas, originally, investors paid for credit ratings through a subscription, issuers started to pay for the assignment of credit ratings after the introduction of the issuers pay model. Up until today, most credit rating agencies issue credit ratings on their websites which are freely available to the public. Although the subscription based model is more inde-

29 *E.g.* Coffee 2006, p. 288 and Darbellay 2013, p. 20.
30 Darbellay 2013, pp. 20-21 and Partnoy 2002, p. 8. *Cf. also e.g.* Coffee 2006, pp. 288-289 and Cantor & Packer 1994, p. 6.
31 Darbellay 2013, p. 20, White 2009, p. 2 and Coffee 2006, p. 289.
32 This term is used, amongst others, by Darbellay 2013, p. 40 and by White 2010, p. 91.
33 *Cf.* Darbellay 2013, p. 23.
34 *See* Cantor & Packer 1994, p. 5.
35 Darbellay 2013, p. 23.
36 Darbellay 2013, p. 23.
37 Darbellay 2013, p. 24 and Coffee 2006, p. 295. As issuers used credit ratings for regulatory purposes, they were prepared to pay for the assignment of credit ratings. Some smaller credit rating agencies, such as Egan-Jones Ratings, still generate revenues on a subscription basis.

pendent, it was less profitable to credit rating agencies due to the public good character of the information provided by credit ratings.[38] The public good character of the information provided by credit ratings means that once published to a few investors, it is difficult to exclude other non-paying investors from receiving and using the information given by the credit rating, because the information provided by credit ratings can be easily copied by other investors.[39] As a consequence, investors were not prepared to pay (high) fees for credit ratings. Finally, since the 1970s, credit rating agencies have managed to increase their revenues by assigning credit ratings to structured finance products.[40] Due to the complexity of structured finance products and the fact that issuers needed credit ratings to be able to sell the structured finance products in the financial markets, credit rating agencies could ask high fees for the assignment of those ratings. Eventually, credit rating agencies started to generate major parts of their revenues from rating structured finance.[41]

3.2.3 Inaccurate credit ratings and (self-)regulation

Credit rating agencies became discredited during the 1990s and 2000s, for having assigned inaccurate credit ratings to legal entities such as Enron, WorldCom and Parmalat.[42] The US entities Enron and WorldCom and the Italian entity Parmalat defaulted at the beginning of the 2000s. Prior to the defaults, these legal entities had gone through periods of massive growth, in which financial frauds were committed.[43] In the aftermath of these defaults, it was questioned how these frauds could have escaped the attention of boards of directors and gatekeepers such as accountants and credit rating agencies.[44] Credit rating agencies had, for instance, downgraded their credit ratings only days prior to Enron, WorldCom and Parmalat filing for bankruptcy.[45] Investors brought proceedings against credit rating agencies (and other gatekeepers) in relation to these defaults. Succeeding in claims for credit rating agency liability under US law proved, however, difficult for investors. First, because rule 436 (g) of the Securities and Exchange Commission under the Securities Act 1933 excluded credit rating agencies from expert liability for

38 Langohr & Langohr 2008, p. 411. *See for a detailed description on the reasons why credit rating agencies changed to the issuer pays model* Simon 2017, pp. 35-36.
39 Langohr & Langohr 2008, p. 412. *Cf.* Coffee 2006, p. 295.
40 Darbellay 2013, p. 25 and Coffee 2006, p. 296.
41 Coval, Jurek & Stafford 2008, p. 4.
42 *See* Coffee 2006, p. 297.
43 Coffee 2006, pp. 15 ff. and Ferrarini & Giudici 2005, especially pp. 12-13.
44 Coffee 2006, pp. 15-16.
45 *See* Coffee 2006, p. 34. *On Enron and WorldCom in particular*, US Senate Report on the Credit Rating Agency Reform Act of 6 September 2006, no. 109-326, p. 8, available at www.congress.gov/109/crpt/srpt326/CRPT-109srpt326.pdf, last accessed at 31 August 2019. *On Enron in particular*, Hemraj 2015, p. 55.

false statements included in registration statements under Section 11 Securities Act of 1933.[46] Second, because credit rating agencies in some proceedings successfully claimed that rating activities were comparable to journalism and, therefore, qualified as opinions that deserved protection based on freedom of speech under the First Amendment of the US Constitution.[47]

In the 2000s, the credit rating industry became more heavily regulated. The International Organization of Securities Commissions (IOSCO) published a Code of Conduct Fundamentals for Credit Rating Agencies in 2004. This Code of Conduct aimed to improve investor protection, to enhance the fairness, efficiency and transparency of financial markets and to reduce systemic risk at the financial markets.[48] The influence of the Code on the behaviour of credit rating agencies turned out to be limited. One of the former European Commissioners for Internal Market and Services even called the Code a 'toothless tiger' in 2008.[49] Furthermore, in 2006, the US legislature introduced the Credit Rating Agency Reform Act of 2006 in response to the defaults of Enron and WorldCom and to the struggles of the SEC to properly arrange for regulatory standards concerning NRSROs.[50] The US legislature aimed to protect investors and to serve the public interest by improving the quality of credit ratings and by enhancing the credit rating industry's accountability, transparency and competition.[51] The Credit Rating Agency Reform Act of 2006, however, neither deleted SEC rule 436 (g) nor arranged for rights of redress for issuers and investors. Moreover, when the Credit Rating Agency Reform Act of 2006 entered into force mid-2007, the subsequent wave of public and political commotion on credit rating agencies would already present itself shortly after the outbreak of the global financial crisis.

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46 Darbellay & Partnoy 2012, p. 17, Partnoy 2006, pp. 83-84 and Partnoy 2002, pp. 18-19. A registration statement is a set of documents, including a prospectus, that issuers must file with the SEC in order to offer or sell securities to the public in the US (Vidal & Joosten 2011, p. 11). *In detail* section 3.2.4.4 (b).

47 Darbellay & Partnoy 2012, pp. 16-17, Partnoy 2006, p. 84 and Partnoy 2002, p. 20. As explained by Partnoy, some courts refused to protect credit rating agencies under the freedom of speech and the right to freedom of speech was not absolute (Partnoy 2006, pp. 86-87).

48 Code of Conduct Fundamentals for Credit Rating Agencies, Technical Committee of IOSCO, December 2004, p. 1, www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf, last accessed at 31 August 2019. *Cf. also* Hemraj 2015, p. 73.

49 The speech in the press conference on credit rating agencies of former European Commissioner for Internal Market and Services C. McCreevy on 12 November 2008 that can be found on http://europa.eu/rapid/press-release_SPEECH-08-605_en.htm?locale=EN, last accessed at 31 August 2019.

50 *Cf.* US Senate Report on the Credit Rating Agency Reform Act of 6 September 2006, no. 109-326, p. 1, available at www.congress.gov/109/crpt/srpt326/CRPT-109srpt326.pdf, last accessed at 31 August 2019. *Cf. also* Horsch 2014, p. 232.

51 US Senate Report on the Credit Rating Agency Reform Act of 6 September 2006, no. 109-326, p. 2, available at www.congress.gov/109/crpt/srpt326/CRPT-109srpt326.pdf, last accessed at 31 August 2019.

3.2.4 Global financial crisis, regulatory frameworks and liability threats

3.2.4.1 Financial crisis

Credit rating agencies became discredited again during the global financial crisis, which started in 2007. The global financial crisis started off in the United States with a crisis in the housing market,[52] and eventually spread across the entire world. In the years prior to the outbreak of the crisis, in the US, the financial markets were not heavily regulated and financial institutions took on large amounts of debts.[53] Banks provided mortgages to households on a large scale, and cleaned their balance sheets by reselling the mortgages on the financial markets. To be able to sell the mortgages, they were pooled and Special Purpose Vehicles issued structured finance products such as collateralised debt obligations and, more in particular, mortgage-backed securities (section 3.3.2.3).[54] However, when the housing bubble burst in the US, the mortgages – some of which had been supplied to borrowers who were insufficiently creditworthy and were even described as 'toxic mortgages'[55] – defaulted and the structured finance products backed by those mortgages generated huge losses. As a response, banks transferred the mortgages from the Special Purpose Vehicle back to their balance sheets,[56] which turned the housing crisis into a banking crisis.

Credit rating agencies attached credit ratings to the structured finance products. The products were structured in such way that credit rating agencies assigned AAA ratings to these products, indicating that they were creditworthy investments with a relatively low chance of default.[57] But, at the beginning of the crisis, the 'safe' AAA rated investments turned out to be worthless, and credit rating agencies were accused of having sent signals that were too positive with regard to the creditworthiness of this type of financial products to the financial markets.[58] The US Financial Inquiry Commission even concluded that 'credit rating agencies were essential cogs in the wheel of financial destruction', because the structured finance products could not be marketed and sold without 'their seal of approval'.[59] Studies have shown that credit rating agencies assigned inaccurate credit ratings to structured finance

52 Rogge 2016, p. 74.
53 *Cf.* 'The Financial Crisis Inquiry Report. Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States', 25 February 2011, pp. xviii-xx, available at www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf last accessed at 31 August 2019.
54 *Cf.* The Financial Crisis Inquiry Report 2011, p. xvii.
55 *Cf.* The Financial Crisis Inquiry Report 2011, pp. xxiii-xxiv.
56 Rogge 2016, p. 72.
57 Baumgartner 2015, pp. 492-493.
58 *Cf.* SEC(2008) 2745, p. 4.
59 The Financial Crisis Inquiry Report 2011, p. xxv. *Cf. also* The Financial Crisis Inquiry Report 2011, pp. 44 ff. and 146.

products. Subsequent to the outbreak of the crisis, the big three had to downgrade their structured finance credit ratings massively.[60] For instance, Moody's downgraded 83% of the AAA mortgage securities assigned in 2006.[61] A key flaw in the structured finance rating models was that they assumed securitisations created safer financial products by pooling various mortgages (diversification), while there was in fact a strong correlation between the mortgages.[62] Moreover, the US Financial Inquiry Commission concluded that credit rating agencies valued market share and profit considerations over rating quality and integrity.[63]

Intentional malpractice within the credit rating industry has been implied, but concrete evidence of the existence of such intentional malpractice remained limited.[64] A well-known statement by an employee of Standard & Poor's reads that a transaction 'could be structured by cows and we would rate it.'[65] In 2014, however, the SEC more carefully stated that credit rating agencies 'might' have had an incentive to generate their revenues 'by relaxing rating standards, inflating credit ratings, facilitating the sale of asset-backed securities by a small number of large issuers, and reducing due diligence in the presence of investors that solely rely on credit ratings'.[66] Empirical research conducted by, for instance, Griffin & Tang showed that credit rating agencies did not always abide by their quantitative models when they assigned credit ratings.[67] They found that only part of the AAA ratings of CDOs could be explained by the credit risk models of credit rating agencies, and that adjustments amounted 'to an additional 12.1% AAA for the average CDO'. Moreover, the adjustments were 'positive predictors of future downgrades'.[68] Furthermore, they concluded that '1.3% of AAAs [meaning AAA rated CDOs] comply with the publicized AAA criterion, 4.8% comply with the publicized AA+ criterion, and 92.5% comply with the publicized AA criterion',[69] implying that part of the

60 The Financial Crisis Inquiry Report 2011, p. 242 and SEC(2008) 2745, p. 4. *Also cf. e.g.* Baumgartner 2015, pp. 494-495 and Coffee 2013, pp. 88 ff.
61 The Financial Crisis Inquiry Report 2011, p. xxv.
62 The Financial Crisis Inquiry Report 2011, pp. 149-150.
63 The Financial Crisis Inquiry Report 2011, p. 212.
64 *Cf. e.g.* SEC(2008) 2745, p. 6 and SEC, Federal Register 15 September 2014, pp. 55082-55083, both carefully making such allegations. Griffin & Tang 2010, p. 2 and *cf.* Ashcraft, Goldsmith Pinkham & Vickery 2010, p. 1.
65 Opening Statement of Rep. H.A. Waxman Chairman, Committee on Oversight and Government Reform Credit Rating Agencies and the Financial Crisis, 22 October 2008, available at https://oversight.house.gov/sites/democrats.oversight.house.gov/files/documents/20081022102221.pdf, last accessed at 31 August 2019. *Also* Baumgartner 2015, p. 495.
66 SEC, Federal Register 15 September 2014, pp. 55082-55083.
67 Griffin & Tang 2010. *Also* SEC, 'Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies', July 2008, pp. 14 and 19, available at www.sec.gov/news/studies/2008/craexamination070808.pdf, last accessed at 31 August 2019.
68 Griffin & Tang 2010, p. 27.
69 Griffin & Tang 2010, p. 20.

senior tranches of structured finance transactions should not have received AAA ratings in the first place. Griffin & Tang's study also demonstrated that the deviations could not be explained by manager experience or credit enhancement.[70] However, it did not confirm the underlying reasons for the deviations of the models by credit rating agencies.[71]

3.2.4.2 Possible causes of inaccurate structured finance ratings

The underlying causes of the inaccurate structured finance ratings are generally sought in the inadequate 'incentivisation' of credit rating agencies, which did not encourage them to ensure the assignment of high quality credit ratings. Coffee remarked that 'the major credit rating agencies simply had too little incentive to "get it right"'.[72] A combination of the functions of credit ratings (section 3.3.3) and certain features of the credit rating industry contributed to the incorrect 'incentivisation' of credit rating agencies and the assignment of inaccurate structured finance ratings.[73]

First, the independence of the credit rating industry was compromised by multiple conflicts of interest of credit rating agencies and their rating analysts.[74] The earning model of credit rating agencies forms the main source of conflicts of interest. The dominance of the issuer pays model indeed entails that the entity who pays for the credit rating is the entity that is to be rated. Thereby, this earning model provides incentives to inflate credit ratings to the benefit of rated entities or its financial instruments in order (to continue) to attract business.[75] The risks of conflicts of interests are exacerbated by ancillary services provided by credit rating agencies[76] and by the ownership structure of credit rating agencies.[77]

Second, the lack of competition in the credit rating industry did not incentivise credit rating agencies to ensure the assignment of high quality credit

70 Griffin & Tang 2010, p. 27.
71 *As indicated by the SEC, see* SEC, Federal Register 15 September 2014, p. 55082 (fn. 37).
72 Coffee 2013, p. 84. *Also e.g.* Darbellay 2013, p. 120 and Pagano & Volpin 2010, p. 404. It is generally agreed upon that credit rating agencies did not have sufficient incentives to ensure the assignment of accurate credit ratings, but there is less agreement on how to solve this problem. One of the main questions is whether one should focus on credit rating agencies' conflicts of interest or on the regulatory use of credit ratings. *See again,* Coffee 2013, p. 84.
73 *For another overview, reference is made to the problem tree of the European Commission*, SEC(2011) 1354 final, p. 10.
74 *E.g.* SEC(2011) 1354 final, p. 10, SEC(2008) 2745, p. 11 ff. and SEC Summary Report 2008, p. 22.
75 SEC(2011) 1354 final, p. 10, SEC(2008) 2745, pp. 11-12 and SEC Summary Report 2008, p. 23. *Also e.g.* Darbellay 2013, pp. 120-122 and Pagano & Volpin 2010, pp. 412-413.
76 SEC(2008) 2745, pp. 12-13. *Also e.g.* Darbellay 2013, pp. 122-124, Pagano & Volpin 2010, p. 413.
77 SEC(2011) 1354 final, p. 10 and p. 20.

ratings.[78] The oligopoly of Fitch Ratings, Moody's Investors Service and Standard & Poor's Ratings Services indeed practically ensures them of clients. The lack of competition is caused by the nature of credit rating activities. The credit rating industry is reputation based, so that newcomers face high (reputational) entry barriers.[79] Building up a good reputation is difficult because issuers and investors will have a preference for credit ratings assigned by credit rating agencies that already have a good reputation, while, in order to get such a good reputation, the credit rating agencies have to assign good ratings first. These high entry barriers have been exacerbated by the regulatory licence system – for example, the US NRSRO system.

Third, the regulatory use[80] of credit ratings in legislation incentivised credit rating agencies and financial markets in a wrong way. The regulatory use of credit ratings effectively requires issuers to apply for credit ratings, thereby providing credit rating agencies with clients. The guarantee of clientele does not incentivise credit rating agencies to ensure the quality of their credit ratings. Moreover, issuers do not care so much about the quality of credit ratings and may not control the work done by credit rating agencies properly, as long as they receive certain credit ratings to comply with regulatory requirements. Furthermore, the regulatory use has the negative side effect of encouraging overreliance on credit ratings by the financial markets (section 3.2.4.3).[81]

The combination of the three factors described caused credit rating agencies to have too little incentive to ensure the assignment of high quality credit ratings. This problem was exacerbated by a lack of liability threats.[82] Credit rating agencies faced hardly any negative consequences from assigning incorrect credit ratings.

3.2.4.3 Aggravated effects due to overreliance

Although it was the credit rating agencies who assigned inaccurate structured finance ratings, one must not lose sight of the fact that the effects of the inaccurate credit ratings were aggravated due to an overreliance on credit ratings by the financial markets.[83] Market participants sometimes blindly relied on

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78 SEC(2011) 1354 final, p. 10 and p. 17. Although too little competition may cause credit rating agencies not to care about their reputational capital (because issuers have limited choice to turn to other credit rating agencies), too much competition in combination with the issuer pays model will not improve the quality of credit ratings either. Such a combination might lead to 'rating shopping' (*cf.* SEC(2008) 2745, pp. 13-14) by issuers and 'a race to the bottom': issuers can threaten to turn to another credit rating agency which incentivises credit rating agencies to inflate credit ratings in order to keep up their revenues (Darbellay 2013, pp. 124-125 and 127 and Coffee 2013, p. 86). *Also* Pagano & Volpin 2010, pp. 415-416.

79 SEC(2011) 1354 final, p. 17. *Also* Coffee 2013, p. 86.

80 Section 3.3.3.

81 SEC(2011) 1354 final, p. 11. *Also* Darbellay 2013, p. 136.

82 *Cf.* SEC(2011) 1354 final, pp. 10 and 18. *Also* Pagano & Volpin 2010, p. 413.

83 *Cf.* SEC(2011) 1354 final, pp. 10-11 ff. *Also cf.* Darbellay 2013, pp. 134-137.

credit ratings and did not conduct their own assessments of issuers' creditworthiness. Overreliance was stimulated by the regulatory use of credit ratings,[84] the lack of transparency on the limits of structured finance ratings[85] and the large complexity of structured finance products.[86] Overreliance is problematic because it can negatively affect market stability. When investors only rely on credit ratings, the financial markets respond strongly to credit ratings and changes to these, which could create market bubbles or downward spirals.[87]

3.2.4.4 Legal developments

(a) European Union

In the aftermath of the global financial crisis, legislatures aimed to increase the accountability of credit rating agencies, and investors started legal proceedings against credit rating agencies for civil liability. Whereas, prior to the financial crisis, self-regulation under the IOSCO Code was thought to be sufficient in the EU, the Union legislature now decided to develop a regulatory framework for credit rating agencies: the first Regulation on credit rating agencies entered into force in 2009 and was amended in 2011, and again in 2013.[88] The regulatory framework provides comprehensive rules for the industry and serves a wide range of objectives (detailed in section 3.4). As regards the enforcement of the rights and obligations created, the regulation foresees in supervisory powers for ESMA, but also in the right of redress for issuers and investors under Article 35a CRA Regulation. The acknowledgment and creation of a right to damages under Article 35a CRA Regulation is a major breakthrough in the history of credit rating agencies. The historical analysis has indeed shown that credit rating agencies were successfully shielded against liability claims in the US on the basis of their freedom of speech and the codification of such a right remained out of the question for a long time.[89]

84 Darbellay 2013, p. 136.
85 SEC(2008) 2745, p. 17.
86 Darbellay 2013, p. 135.
87 *Cf.* SEC(2011) 1354 final, p. 11.
88 Regulation (EC) no. 1060/2009, Regulation (EU) no. 513/2011 and Regulation (EU) no. 462/2013, respectively.
89 Upon the first version of the CRA Regulation, the French legislature introduced a special right of redress for issuers and investors under Art. L. 544-5 Code monétaire et financier (section 5.5.2.1).

(b) United States[90]

The US legislature amended the Credit Rating Agency Reform Act of 2006 by the Dodd-Frank Act 2010. At first sight, these amendments appeared to have serious consequences for the opportunities to hold credit rating agencies liable under the Securities Act of 1933[91] and the Securities Exchange Act of 1934[92] as well.

Prior to the introduction of the Dodd-Frank Act 2010, rule 436 (g) of the Securities and Exchange Commission under the Securities Act 1933 exempted credit rating agencies from expert liability for false statements included in registration statements under Section 11 Securities Act of 1933. Credit rating agencies, hence, were not liable for inaccurate credit ratings included in registration statements filed by issuers, such as prospectuses, needed for public offerings. Section 939G Dodd-Frank Act 2010 repealed SEC rule 436 (g), subjecting credit rating agencies to increased liability risks.[93] However, under pressure from the credit rating industry, the repeal eventually did not have any effect. Upon the introduction of Section 939G Dodd-Frank Act 2010, credit rating agencies no longer allowed issuers to include credit ratings in registration statements.[94] This refusal was highly problematic for asset-backed securities issuers, because they were required to include credit ratings in their registration statements by SEC rules.[95] In order to enable issuers to issue asset-backed securities nevertheless and to avoid the disruption of the securitisation market,[96] the Securities Exchange Commission announced it would not enforce issuers' obligations to include credit ratings in their registration statements

90 As indicated in section 1.5, this dissertation does not cover credit rating agency liability under US law. This section, as well as the section on the Australian case *Bathurst Regional Council* (section 3.2.4.4 (c)), serve as a brief description of developments in the context of credit rating agency liability only. For a more detailed overview e.g. Miglionico 2019, no. 4.01 ff. and no. 8.01 ff. and Dumont du Voitel 2018, pp. 361 ff.

91 The Securities Act of 1933 provides rules on the issue of securities at primary markets (*cf.* Vidal & Joosten 2011, p. 8).

92 The Securities Exchange Act of 1934 provides rules on the trading of securities and financial markets (*cf.* Vidal & Joosten 2011, p. 8).

93 In full: Rule 17 CFR 220.436 (g). Haar 2014, p. 321. *Also e.g.* De Bruyne 2019, p. 153, Cash 2019, p. 117, Miglionico 2019, no. 4.25 and no. 8.40, Picciau 2018b, pp. 355 and 374-375, Schantz 2015, pp. 43-45, Darbellay & Partnoy 2012, p. 21 and Brownlow 2011, pp. 111-112 and p. 125.

94 Report from the Committee on Financial Services on the 'Asset-Backed Market Stabilization Act of 2011', 12 August 2011, no. 112-196, p. 2, available at www.congress.gov/112/crpt/hrpt196/CRPT-112hrpt196.pdf, last accessed at 31 August 2019 and www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm, last accessed at 31 August 2019. *Also e.g.* De Bruyne 2019, p. 153, Cash 2019, p. 122, Haar 2014, p. 322, Brownlow 2011, p. 130 and Martin & Franker 2011, p. 20.

95 Under Items 1103 (a) (9) and 1120 of Regulation AB. *See* Brownlow 2011, p. 131 and Martin & Franker 2011, p. 20.

96 *Cf.* Report from the Committee on Financial Services on the 'Asset-Backed Market Stabilization Act of 2011', 12 August 2011, no. 112-196, p. 2, available at www.congress.gov/112/crpt/hrpt196/CRPT-112hrpt196.pdf, last accessed at 31 August 2019.

in November 2010.[97] Thus, issuers could issue asset-backed securities without including the previously required credit ratings in their registration statements. Moreover, in the same year as the US Financial Inquiry Commission concluded that 'credit rating agencies were essential cogs in the wheel of financial destruction',[98] Section 939G Dodd-Frank Act 2010 was even completely repealed by the Asset-Backed Market Stabilization Act of 2011.[99] As a result, the exception under SEC rule 436 (g) was revived and credit rating agencies could not be held liable under Section 11 Securities Act 1933. The increased civil liability risks resulting from Section 939G Dodd-Frank Act 2010 vanished again into thin air.

Furthermore, Section 933 (a) and (b) Dodd-Frank Act 2010 amended the Securities Exchange Act of 1934. Under Article 15E (m) Securities Exchange Act of 1934, the enforcement and penalty provisions of the Securities Exchange Act of 1934 should 'apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws'. If a claim for damages was brought against a credit rating agency, the claimant had to provide facts 'giving rise to a strong interference that the credit rating agency knowingly or recklessly failed' to conduct a reasonable investigation or to obtain reasonable verification.[100] Even though the Securities Exchange Act of 1934 now mentioned the opportunity of claims for civil liability against credit rating agencies, the threshold for civil liability remained challenging for investors.

As already mentioned, credit rating agencies managed to escape civil liability under US law by arguing that their rating activities qualified as opinions, which deserved protection based on freedom of speech under the First Amendment of the US Constitution.[101] Prior to the introduction of the Dodd-Frank Act 2010, however, US courts already seemed to approach the freedom of speech argument in a more sceptical manner.[102] The right to freedom of speech of credit rating agencies was not absolute. Although credit ratings represent a credit rating agency's 'own judgment about the quality

97 Available at www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm, last accessed at 31 August 2019. *Also e.g.* Picciau 2018b, p. 375, Haar 2014, p. 322, Lehmann 2016a, p. 70 and Brownlow 2011, p. 132.

98 The Financial Crisis Inquiry Report 2011, p. xxv. *Cf. also* The Financial Crisis Inquiry Report 2011, pp. 44 ff. and p. 146.

99 Report from the Committee on Financial Services on the 'Asset-Backed Market Stabilization Act of 2011', 12 August 2011, no. 112-196, p. 2, available at www.congress.gov/112/crpt/hrpt196/CRPT-112hrpt196.pdf, last accessed at 31 August 2019. *Also* De Bruyne 2019, p. 153.

100 *Also* De Bruyne 2019, p. 154.

101 Darbellay & Partnoy 2012, pp. 16-17, Partnoy 2006, p. 84 and Partnoy 2002, p. 20. As explained by Partnoy, some courts refused to protect credit rating agencies under the freedom of speech and the right to freedom of speech was not absolute (Partnoy 2006, pp. 86-87).

102 *For this approach cf.* Darbellay & Partnoy 2012, p. 17 and Brownlow 2011, pp. 116-117.

of the bond',[103] they were actionable on the basis of common law fraud if the credit rating agency 'does not believe the opinion and the opinion is not factually well-founded'.[104] Furthermore, if credit ratings were disseminated to a select group of investors, credit rating agencies were not entitled to the same level of protection as in situations in which credit ratings were disseminated to the public at large.[105]

(c) Australia

In November 2012, the Australian case *Bathurst Regional Council v Local Government Financial Service Pty Ltd (No 5)* formed a breakthrough in respect of the civil liability of credit rating agencies. The Federal Court of Australia (New South Wales District Registry) held that Standard & Poor's owed a duty of care to investors under the tort of negligence and breached the required standard of care.[106] In comparison to the English law approach to credit rating agency liability (see section 5.7.2), the decision of the Australian court was quite surprising.

In *Bathurst,* Australian local councils had collectively invested in constant proportion debt obligations (CPDOs) issued by ABN AMRO.[107] Standard & Poor's had assigned an AAA rating to the CPDOs but the CPDOs turned out to be extremely volatile and lost 90% of their value in two years.[108] The Federal Court of Australia held that Standard & Poor's owed a duty of care to the

103 *In Re National Century Financial Enterprises, Inc., Investment Litigation*, 580 F. Supp. 2d 630 (S.D. Ohio. Jul. 22, 2008), 639 and *Compuware Corp. v Moody's Investors Services, Inc.*, 499 F.3d 520 (6th Cir. 2007), 522.

104 *Cf. In Re National Century Financial Enterprises, Inc., Investment Litigation*, 580 F. Supp. 2d 630 (S.D. Ohio. Jul. 22, 2008), 639.

105 *In Re National Century Financial Enterprises, Inc., Investment Litigation*, 580 F. Supp. 2d 630 (S.D. Ohio. Jul. 22, 2008), 640 and *Abu Dhabi Commercial Bank v Morgan Stanley & Co.*, 651 F. Supp. 2d 155 (S.D.N.Y. 2009), 176. *As derived from* Darbellay & Partnoy 2012, p. 17 and Brownlow 2011, p. 117. *Also* De Bruyne 2019, p. 156 and Hemraj 2015, pp. 186-187.

106 *Bathurst Regional Council v Local Government Financial Service Pty Ltd* (No 5) [2012] FCA 1200, paras. 2758 and 2787. This section concentrates only on the parts of *Bathurst* on the existence of a duty of care and the required standard of care under the tort of negligence. *For a broader overview of Australian law and other Australian decisions e.g.* Miglionico 2019, no. 10.01 ff.

107 Constant proportion debt obligations are highly complex derivatives. In *Bathurst*, the investors (protection sellers) entered into synthetic credit default swaps with ABN AMRO (protection buyers). Under the credit default swap contracts, the investors sold protection against potential defaults by entities listed on the Globoxx index (a combination of the indices CDX and iTraxx). Hence, the investors would earn or lose money depending on the creditworthiness of the companies listed on the Globoxx index. See the summary of *Bathurst* published by the Federal Court, available at www.judgments.fedcourt.gov.au/judgments/Judgments/fca/single/2012/2012fca1200, last accessed at 31 August 2019, paras. 3-5. The CPDOs were structured in such way that they would receive a high credit rating while paying a coupon rate that could be compared with the coupon rate paid on high risk junk bonds. See S.M. Ishmael, 'A PIK of the ABCDS of arcane credit derivative terminology', *Financial Times* 29 June 2007.

108 Lehmann 2016a, p. 71.

Australian local councils under the tort of negligence.[109] The Federal Court distinguished this case from cases concerning accountant's liability in which the existence of a duty of care was not accepted, since 'a rating is assigned to a financial instrument for the very purpose of communication to the class of potential investors for them to take into account, and rely upon, in deciding whether or not to invest', while '[t]he same cannot be said of a financial audit of a company which is undertaken by an auditor for the company's own purposes and to comply with the company's statutory obligations'.[110] Moreover, Standard & Poor's was assumed to have known that investors would rely on its credit rating because the business of rating structured finance products is dependent upon the idea that investors need credit ratings to assess the creditworthiness of CPDOs – the court concluded 'it is difficult to conceive of any other purpose for the rating'.[111] The fact that credit ratings could be qualified as opinions, did not preclude the existence of a duty of care to exercise reasonable care and skill in the assignment of the credit rating. Furthermore, it was 'immaterial' that Standard & Poor's was not aware of the precise identity of the investors.[112] Standard & Poor's was held to have possessed sufficient information to define the class of potential investors to whom it might be liable.[113]

Moreover, the Federal Court held that Standard & Poor's breached the required standard of care. Standard & Poor's was considered not to have 'a reasonable basis to conclude that the notes had an "extremely strong capacity to meet financial commitments"' and failed to act with reasonable care as a credit rating agency.[114] Furthermore, the Federal Court found:

> 'These matters do not involve mere matters of judgment upon which reasonable experts might differ. They do not involve mere mistakes or errors of judgment in a complex and difficult area. They involve failures of such a character that no reasonable ratings agency exercising reasonable care and skill could have committed in the rating of the CPDOs. Contrary to S&P's submissions the problem is not that

109 *Bathurst Regional Council v Local Government Financial Service Pty Ltd (No 5)* [2012] FCA 1200, paras. 2814-2819. *See also* Sahore 2015, p. 444.
110 *Bathurst Regional Council v Local Government Financial Service Pty Ltd (No 5)* [2012] FCA 1200, para 2758.
111 *Bathurst Regional Council v Local Government Financial Service Pty Ltd (No 5)* [2012] FCA 1200, para 2759.
112 *Bathurst Regional Council v Local Government Financial Service Pty Ltd (No 5)* [2012] FCA 1200, para 2778.
113 *Bathurst Regional Council v Local Government Financial Service Pty Ltd (No 5)* [2012] FCA 1200, para 2754.
114 *Bathurst Regional Council v Local Government Financial Service Pty Ltd (No 5)* [2012] FCA 1200, paras. 2829-2830. *See also* Sahore 2015, p. 440.

> the analysis was not rigorous. The problem is that the analysis was fundamentally flawed, unreasonable and irrational in numerous respects as identified.'[115]

The decision of the Federal Court of Australia was upheld on appeal. While Standard & Poor's argued that adopting a duty of care 'would be to turn predictions about the future into guarantees', the Federal Court of Appeal of Australia rejected this submission for ignoring principles established by law.[116] It decided that Standard & Poor's owed a duty 'to exercise reasonable care in forming and expressing the relevant opinion about the credit risk of the Rembrandt notes', because Standard & Poor's 'knew of an ascertainable class of persons "who is or are reliant, and therefore vulnerable"'. The duty did not involve the obligation to assign the correct credit rating or to protect the Australian local councils from suffering loss.[117] The Court of Appeal rejected the submission that Standard & Poor's did not owe a duty of care, because they did not know the identity of the investors. The class was considered not indeterminate, because Standard & Poor's knew that each member of the class was an investor in the specific CPDOs.[118]

Legal scholars concluded that the outcome in *Bathurst* was strongly influenced by the specific circumstances of the case, such as the fact that the CPDOs were bespoke for certain institutional investors[119] and that the CPDOs could not be traded on the secondary markets.[120] Be this as it may, the rulings nevertheless indicate that credit rating agency liability under the tort of negligence under Australian law is not impossible. In particular circumstances, credit rating agencies owe a duty of care to exercise reasonable care and skill in assigning credit ratings, and cannot escape civil liability on the sole basis of the fact that credit ratings are opinions.

3.2.5 Recovery and settlements

At the time this dissertation is published, the outbreak of the global financial crisis lies more than ten years behind us. The regulatory changes made in the aftermath of the crisis have been in force for some years, and the credit rating industry has recovered from the crisis.

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115 *Bathurst Regional Council v Local Government Financial Service Pty Ltd (No 5)* [2012] FCA 1200, para 2836.
116 *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65, para 572. Harding-Farrenberg & Donovan 2015, p. 94.
117 *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65, paras. 566, 600, 1250, 1255 ff. and 1302. *Also* De Bruyne 2019, p. 156.
118 *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65, paras. 587 and 593.
119 Lehmann 2016a, p. 71. *Cf.* Harding-Farrenberg & Donovan 2015, pp. 97-98.
120 Sahore 2015, pp. 446 and 451.

ESMA Reports show that by 2013 revenues and operating profits of credit rating agencies had returned to the same level as before the financial crisis.[121] The credit rating industry continues to be a large business: revenues and profits are high and the amount of outstanding credit ratings is enormous.[122] Over 2014, the total revenue of the rating business of McGraw Hill Financial (the holding company of Standard & Poor's) and Moody's Corporation were EUR 1,851 million and EUR 1,708 million, respectively.[123] At the end of June 2015, the amounts of outstanding structured finance ratings of Standard & Poor's, Moody's and Fitch were 61,038, 61,937 and 41,303, respectively.[124] Notwithstanding the efforts made to increase competition by the regulatory frameworks in force, the credit rating industry remains dominated by three credit rating agencies: Fitch Ratings, Moody's Investors Service and Standard & Poor's Ratings Services.[125] ESMA's market share calculations (based on credit rating agencies' revenues) even show an increase in the combined market share of these three credit rating agencies: 90.44% (in 2013), 91.89% (in 2014), 92.85% (in 2015), 93.18% (in 2016) and 93.40% (in 2017).[126] Hence, the remaining 20 smaller credit rating agencies all together had a combined market share of 6.82% in 2017. Nevertheless, some of the smaller credit rating agencies did develop larger market shares in specific rating areas.[127]

Credit rating agencies settled multiple civil liability claims brought against them for the assignment of inaccurate structured finance ratings prior to the global financial crisis. Following the Australian decisions in *Bathurst*, credit rating agencies settled disputes with several Australian local councils in 2016,

121 ESMA/2015/280, p. 12 and *see* ESMA/2015/1472, p. 32. Over 2014, Standard & Poor's Rating Services suffered an operating loss caused by, amongst others, USD 1,6 billion spent on legal and regulatory settlements. *See* 2014 Annual Report McGraw Hill Financial, p. 20, available at http://investor.spglobal.com/Cache/1500085839.PDF?O=PDF&T=&Y=&D=&FID=1500085839&iid=4023623, last accessed at 31 August 2019.

122 Details can be found in the Annual Reports published by credit rating agencies (or their holding companies) and on the website of CEREP, a central repository set up by ESMA that publishes the rating activity statistics and rating performance statistics of credit rating agencies.

123 ESMA/2015/1472, p. 33.

124 Available at http://cerep.esma.europa.eu/cerep-web/statistics/ratingActivity.xhtml, last accessed at 31 August 2019.

125 *On the corporate structure of the Big Three*, Simon 2017, pp. 14-18. *Also* Cash 2019, pp. 6-8.

126 ESMA/2014/1583, p. 6, ESMA/2015/1879, p. 8, ESMA/2016/1662, p. 6, ESMA33-5-209, p. 6 and ESMA33-9-281, p. 6, respectively.

127 *Cf.* SEC, 'Annual Report on Nationally Recognized Statistical Rating Organizations', December 2018, www.sec.gov/files/2018-annual-report-on-nrsros.pdf, last accessed at 31 August 2019, p. 7 and the calculations of ESMA33-9-281, pp. 8-9. Examples of these smaller credit rating agencies are CERVED Group S.p.A. (an Italian credit rating agency), DBRS Ratings Limited (headquartered in Canada), AM Best Europe Rating Services (with a focus on the insurance sector), The Economist Intelligence Unit Ltd (the research and analysis division of The Economist Group, sister company to The Economist newspaper – assigning unsolicited ratings only) and Egan Jones (working on the basis of paid subscriptions).

for an amount of USD 142 million,[128] and 2018, for an amount of USD 157 million.[129] The largest post-crisis settlements were concluded in the United States. Standard & Poor's agreed on paying USD 1.5 billion to the US Department of Justice, 19 states and the District of Columbia in 2015.[130] Moody's agreed on paying USD 864 million to the US Department of Justice, 21 states and the District of Columbia in 2017.[131] From a European perspective, the global financial crisis did not lead to large settlements. Italian prosecutors started criminal proceedings against analysts of Standard & Poor's and Fitch for market manipulation relating to downgrades of Italian sovereign credit ratings in 2011 and 2012. However, the Tribunale Penale di Trani dismissed the accusations in 2017.[132] Finally, up to now, Article 35a CRA Regulation[133] has not proved itself as a harbinger of change for the number of successful claims for damages against credit rating agencies within the EU. Claims based on Article 35a CRA Regulation were brought in Germany, but all claims were rejected thus far.[134]

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128 In February 2016, Standard & Poor's agreed on this settlement with 92 Australian groups, www.reuters.com/article/us-australia-s-p-court-idUSKCN0VT04T, last accessed at 31 August 2019.

129 In August 2018, Standard & Poor's agreed on this settlement with pension funds and Australian local governments, www.reuters.com/article/us-australia-s-p/sp-settles-landmark-derivatives-rating-lawsuit-in-australia-idUSKBN1KV09O and www.reuters.com/article/us-australia-s-p/sp-others-paid-157-million-to-settle-landmark-australian-lawsuit-idUSKCN1LF0U9, last accessed at 31 August 2019.

130 *See* www.reuters.com/article/us-s-p-settlement/sp-reaches-1-5-billion-deal-with-u-s-states-over-crisis-era-ratings-idUSKBN0L71C120150203, last accessed at 31 August 2019.

131 *See* www.reuters.com/article/us-moody-s-credit-idUSKBN14X2LP, last accessed at 31 August 2019.

132 Tribunale Penale di Trani 26 September 2017, no. 837/17 Reg.Sent. Furthermore, several civil proceedings were started in Italy. This dissertation does not discuss Italian case law. *For an Italian dissertation on credit rating agency liability e.g.* Picciau 2018a. *For a dissertation on credit rating agency liability involving a comparison between German and Italian law* Rinaldo 2017.

133 Noting that Art. 35a CRA Regulation only became applicable as from 20 June 2013, Art. 2 CRA III Regulation and *OJ* 31 March 2013, L 146.

134 *E.g.* Amtsgericht Neuss 28 December 2016, 80 C 3954/15, ECLI:DE:AGNE:2016:1228.80C3954.15.00, *BeckRS* 2016, 130332, Landgericht Düsseldorf 17 March 2017, 10 O 181/15, ECLI:DE:LGD:2017:0317.10O181.15.0A and Oberlandesgericht Düsseldorf 8 February 2018, I-6 U 50/17, ECLI:DE:OLGD:2018:0208.I6U50.17.00, *BeckRS* 2018, 2321. *See e.g.* section 3.5.3.3 (b).

3.3 Credit ratings

3.3.1 Character and types

Credit ratings are expert opinions on creditworthiness assigned to fixed income financial instruments and issuers of such financial instruments.[135] Credit rating agencies assign credit ratings to entities such as companies and financial institutions, but also to states, municipalities, universities and hospitals, for instance. Credit ratings can also concern specific financial instruments, as long as they are of a fixed income nature. Examples are debts in general, other financial obligations, debt securities (bonds)[136] and preferred shares.[137] Credit rating agencies hence do not rate normal shares, which belong to equity capital of the issuer.

Credit rating agencies can assign credit ratings at an issuer's request or on their own motion. Credit ratings of the first category are called 'solicited credit ratings'. A credit rating agency and an issuer enter into a rating contract for the assignment of a solicited credit rating, and the issuer pays the credit rating agency for the assignment. In contrast, credit rating agencies assign 'unsolicited credit ratings' on their own motion, without a request or permission from the rated entity or financial instruments. These credit ratings serve to complete the palette of solicited credit ratings. Unsolicited credit ratings are assigned to states, for instance ('sovereign ratings').

Difficult questions are what involves an accurate credit rating, and what makes a credit rating inaccurate. The complexity is related to the character of credit ratings. Credit ratings provide opinions and information on the relative chance that an issuer will default on its financial obligations in general, or will default on a particular fixed income financial instrument ('credit risk').[138] The character of credit ratings, therefore, is 'fundamentally forward looking'. Furthermore, they qualify as opinions about creditworthiness rather than recommendations, advice or guarantees in respect of creditworthiness.[139] As credit ratings indicate relative chances and probabilities, the default of an issuer (on its financial instruments) does not determine the accuracy of a credit rating. A high credit rating indicates a small chance of default, but indeed

135 Art. 3 (1) (a) CRA Regulation. Under Recital 8 CRA III Regulation, credit ratings are 'not mere' opinions. Credit rating agencies assign all different types of credit ratings, *cf. e.g.* Standard & Poor's rating definitions, available at www.standardandpoors.com//en_US/web/guest/article/-/view/sourceId/504352, last accessed at 31 August 2019 and Moody's rating definitions, available at www.moodys.com/sites/products/ProductAttachments/AP075378_1_1408_KI.pdf, last accessed at 31 August 2019.

136 Such as government bonds, corporate bonds and municipal bonds.

137 Art. 3 (1) (a) CRA Regulation and IOSCO Report 2003, p. 1.

138 *E.g.* IOSCO Report 2003, p. 3. The exact definition of a credit rating differs slightly per credit rating agency (Gaillard 2010, pp. 16-19).

139 *See* Langohr & Langohr 2008, p. 85.

even a small risk can materialise. If a highly rated entity defaults, the question arises whether the credit rating was inaccurate or whether a small risk at default simply materialised.[140]

3.3.2 Assignment of credit ratings

3.3.2.1 Formal proceedings[141]

Each credit rating agency uses its own formal proceedings and methodologies to assign credit ratings to issuers and financial instruments. Therefore, this section only provides a general impression of how the assignment takes place. The rating process often starts upon the request from an issuer for the assignment of a solicited credit rating.[142] After the conclusion of a rating contract, a team of rating analysts – under the responsibility of a lead analyst – investigates what credit rating must be assigned. A rating committee must approve the credit rating proposed by the team of analysts.[143] Upon the completion of this procedure, a credit rating agency submits the credit rating, corresponding reports and press releases to the issuer. If substantial changes in the state of the issuer have occurred, the issuer can ask the credit rating agency to reconsider the credit rating.[144] Finally, the credit rating is published on the website of the credit rating agency and is often freely available to the public.[145] Subsequent to the publication, credit rating agencies monitor issuers and their financial instruments to ensure credit ratings remain accurate.[146]

A credit rating agency's fee for the assignment of credit ratings depends on the particular features of an issuer or its financial instruments.[147] The fee can involve a fixed sum or a percentage expressed in basis points. To provide an impression of the sums and percentages involved, Standard & Poor's for instance specifies that they charge 'up to 6.95 basis points for most transactions' and a minimum fee of $100,000 for most transactions for the sectors 'corporate'

140 *Cf. on the incorrectness of credit ratings e.g.* Schantz 2015, p. 54.
141 *Information for this description of the formal proceedings is mainly derived from* Garcììa Alcubilla & Ruiz del Pozo 2012, pp. 18 ff.
142 Darbellay 2013, p. 34 and Garcììa Alcubilla & Ruiz del Pozo 2012, p. 18. Some issuers even appoint a 'rating adviser'. A rating adviser acts as an intermediary between the issuer and the credit rating agency. Langohr & Langohr 2008, pp. 165-166.
143 Darbellay 2013, p. 34, Garcììa Alcubilla & Ruiz del Pozo 2012, pp. 20-21 and *see* AMF Report 2007, p. 40.
144 Garcììa Alcubilla & Ruiz del Pozo 2012, p. 21.
145 Although the underlying reports often disappear behind a paywall after a certain period of time, Garcììa Alcubilla & Ruiz del Pozo 2012, p. 22 and, *more extensively*, Langohr & Langohr 2008, pp. 173-174.
146 Langohr & Langohr 2008, pp. 174 ff. *Cf.* Darbellay 2013, pp. 36-37 and Garcììa Alcubilla & Ruiz del Pozo 2012, p. 22.
147 *Cf.* Langohr & Langohr 2008, p. 413.

and 'sovereigns'. The fees for credit ratings in the field of structured finance 'range up to 12 basis points'. Yet, Standard & Poor's explains that higher fees apply to more complex transactions.[148]

3.3.2.2 *Rating methodologies*

Credit rating agencies employ their own rating methodologies, models and underlying key assumptions. These methodologies, models and assumptions vary per type of issuer or financial instruments. Taking the long-term issue credit ratings of Standard & Poor's as an example, important components for the assignment of such credit ratings are (1) 'the likelihood of payment', i.e. whether the issuer is able and willing to fulfil its obligations in accordance with the terms of the obligations; (2) the nature and terms of the obligations; and (3) the protection offered to credit ratings in the event of bankruptcy.[149] Credit rating agencies that are registered in the EU cannot keep information on methodologies, models and assumptions entirely secret; they are required to disclose their rating methodologies, models and key rating assumptions under Article 8 (1) CRA Regulation. Annex I Section E (I) (5) CRA I Regulation specifies that, for instance, mathematical and correlation assumptions used must be available to the public. The Union legislature introduced this obligation to empower investors to decide whether they wish to rely on credit ratings, but the Union legislature did not wish to require credit rating agencies to publish sensitive business information or to bar innovation.[150]

Assessments of creditworthiness combine quantitative data with qualitative factors.[151] Quantitative data involve, for instance, an issuer's revenues, cash flows and dividends.[152] Qualitative factors involve, for instance, an issuer's commercial strategies, growth potential, financial policy and structure, management quality, ownership structure, corporate governance, and existing competition and the surrounding regulatory environment.[153] The political climate in a state can also involve a qualitative factor. As a result, credit ratings do not only reflect objective raw data, but also reflect a more subjective consideration of qualitative components. Credit rating agencies gather their information from publicly available sources, but also receive information from issuers.

148 www.standardandpoors.com/en_US/delegate/getPDF?articleId=2148688&type=COMMENTS&subType=REGULATORY, last accessed at 31 August 2019. To my knowledge, fee schedules of Moody's and Fitch were not publicly available.
149 *See* www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352, last accessed at 31 August 2019.
150 Recital 25 CRA I Regulation.
151 Darbellay 2013, p. 34, Garcìa Alcubilla & Ruiz del Pozo 2012, p. 18 and AMF Report 2007, p. 41.
152 *As derived from* AMF Report 2007, p. 41. *Also* Garcìa Alcubilla & Ruiz del Pozo 2012, pp. 19-20.
153 *As derived from* AMF Report 2007, p. 41. *Also* Garcìa Alcubilla & Ruiz del Pozo 2012, p. 20.

Credit ratings can reflect non-public (inside) information provided by the issuer.[154] Credit rating agencies do not (thoroughly) scrutinise whether the information received is accurate.[155] The CRA Regulation, however, does oblige them to take measures to ensure the information used is reliable and of sufficient quality.[156]

Credit rating agencies turn all information gathered into a single symbol at a rating scale. Rating scales differ per credit rating agency and per issuer or financial obligation. For instance, the long-term issue credit rating scale of Standard & Poor's is AAA, AA, A, BBB, BB, B etc., while Moody's uses a different long-term issue credit rating scale of Aaa, Aa, A, Baa, Ba, B etc. The precise meaning of a certain symbol can vary (slightly) per credit rating agency.[157] The highest ratings can indicate that '[t]he obligor's capacity to meet its financial commitment on the obligation is extremely strong' (AAA-rating, as defined by Standard & Poor's)[158] or that the obligation rated is 'judged to be of the highest quality, with minimal risk' (Aaa-rating, as defined by Moody's).[159]

Credit ratings provide information on the relative chance that an issuer will default on its financial obligations in general or will default on a particular fixed income financial instrument.[160] As a credit rating provides information on relative chances of default, a specific credit rating must be valued in light of the meaning of the other symbols at the rating scale.[161] In general, one can say that the worse the credit rating, the less the capacity of the issuer to meet its financial obligations and the higher the credit risk for investors. For instance, an issuer rated AAA is far less likely to default than an issuer rated B, but the precise difference in chance between the credit ratings is not made explicit.[162] An important distinction is made between investment grade ratings and speculative grade (non-investment grade) ratings. An investment grade rating (for instance, BBB or above pursuant to the long-term issue credit rating scale of Standard & Poor's) indicates high or medium credit quality, which means that the credit risk involved is relatively low. Speculative grade ratings (BB-C ratings pursuant to the long-term issue credit rating scale of Standard & Poor's) are attached to obligations with 'significant speculative characteristics'. This means that the quality and protective characteristics of

154 Garciìa Alcubilla & Ruiz del Pozo 2012, p. 19.
155 Garciìa Alcubilla & Ruiz del Pozo 2012, p. 19. *Cf.* Hemraj 2015, p. 29.
156 Art. 8 (2) CRA Regulation and Recital 35 CRA I Regulation.
157 Gaillard 2010, pp. 16-19.
158 *See* www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352, last accessed at 31 August 2019.
159 *See* www.moodys.com/sites/products/ProductAttachments/AP075378_1_1408_KI.pdf, last accessed at 31 August 2019.
160 *E.g.* IOSCO Report 2003, p. 3.
161 *See* AMF Report 2007, p. 20.
162 *See* Langohr & Langohr 2008, p. 44 and *cf.* AMF Report 2007, p. 20.

these obligations might be 'outweighed by large uncertainties or major exposures to adverse conditions'. The lowest ratings (D ratings pursuant to the long-term issue credit rating scale of Standard & Poor's) are attached to obligations already in default.[163]

3.3.2.3 Structured finance products

Credit rating agencies have been involved in rating structured finance products since the emergence of structured finance transactions in the 1970s. The assignment of structured finance ratings is considered a difficult exercise due to the (highly) complex structures of structured finance transactions. It was the assignment of inaccurate structured finance ratings and the role of credit rating agencies in structured finance transactions prior to the global financial crisis that caused the public and political indignation that led to the CRA Regulation.[164] The role of credit rating agencies in structured finance can be demonstrated by securitisations, which are a particular type of structured finance transactions.[165]

Securitisation transactions can be instigated by parties that hold large amounts of receivables, such as mortgages, car loans, credit card receivables and other debt obligations. This so-called 'originator' wishes to transfer the risks associated with these receivables and to remove the receivables from its balance sheet, while generating profits from trading these risks in the financial markets.[166] To that end, the originator sells receivables associated with different credit risks to a special purchase vehicle (SPV). The SPV finances this sale by issuing notes – bonds, also called asset-backed securities[167] – to the financial markets. The SPV is entitled to the proceedings of the receivables, and uses these proceedings to pay holders of the notes (investors) a fixed amount and interest.[168] The SPV issues notes with different risk profiles, the

163 *See* www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352, last accessed at 31 August 2019.

164 Section 3.2.4.1.

165 Another example of a typical structured finance transaction is a covered bonds transaction (Haentjens & De Gioia-Carabellese 2015, p. 228). This dissertation provides a brief and simplified explanation of securitisations only. *See in more detail on structured finance transactions* Wood 2008, no. 28-01 ff. and Haentjens & De Gioia-Carabellese 2015, pp. 228 ff. *See in more detail on credit ratings and structured finance e.g.* Simon 2017, pp. 59 ff. and Angelé 2014.

166 *On the objectives of securitisations* Haentjens & De Gioia-Carabellese 2015, p. 232.

167 The notes are referred to as 'asset-backed securities' because they are collateralised/backed by the pool of underlying assets (the collateral). Depending on the type of receivables, there are different types of asset-backed securities such as collateralised loan obligations (CLOs), collateralised debt obligations (CDOs) and commercial or residential mortgage-backed securities (CMBS or RMBS). *See, also for more examples*, Wood 2008, no. 28-06.

168 *Description derived from* Haentjens & De Gioia-Carabellese 2015, p. 228 and Wood 2008, no. 28-01. *Cf. also e.g.* Simon 2017, pp. 57-58 and CGFS Report 2005, p. 4. Banks are the most common example of originators.

so-called tranches (senior, mezzanine and junior tranches).[169] If losses are borne, the proceeds of the receivables are paid to senior note holders first. The junior note holders will be paid only if there are proceeds left. As losses are borne by the junior tranches first, junior notes receive a lower credit rating than senior notes and holders of junior notes receive a higher coupon than the holders of senior notes.

By pooling the receivables and by dividing the notes into different tranches, the originator can transfer the risks of the receivables to the noteholders and can generate profits if the total amount of coupon paid to the noteholders is less than the total amount of coupon the SPV receives from the receivables – as this difference is often returned to the originator because the SPV pays a service fee to the originator.[170] To this end, it must be ensured that less coupon is paid to the senior noteholders than is received from the pool of receivables together. Credit rating agencies are indispensable in securitisation transactions, as this goal can be achieved by ensuring senior notes have a better credit rating than the individual receivables.[171] From the investor side, there also is a demand for structured finance products. Structured finance products allow (institutional) investors to diversify their investment risks, by allowing them to invest their assets in segments that would otherwise not be available to them. Moreover, structured finance products provide a high coupon for relatively safe investments.[172]

As compared to the rating of 'simple' financial instruments and entities, credit rating agencies are often more involved in the structuring of securitisations. The credit rating is not the 'outcome', but the 'target' of the rating process.[173] The focus on receiving the highest possible credit ratings for the tranches influences the relationship between a credit rating agency and an issuer. A credit rating agency and an issuer can have prior contact to maximise the size of a tranche, to minimise the quality of the receivables used or to minimise the amount of credit enhancement.[174] Hence, the size of the tranches and their position in the loss distribution is constructed carefully. Contrary to most rating proceedings, the SPV can be allowed to change the structure of the transaction after the assignment of preliminary credit ratings in order to receive a certain credit rating.[175] As a result, the rating process regarding

169 Haentjens & De Gioia-Carabellese 2015, p. 228 and Wood 2008, no. 28-09.
170 Haentjens & De Gioia-Carabellese 2015, p. 232.
171 CGFS Report 2005, pp. 1 and 17.
172 Haentjens & De Gioia-Carabellese 2015, p. 232.
173 *As written by* Garciìa Alcubilla & Ruiz del Pozo 2012, p. 24. *Cf. also e.g.* IOSCO Report 2008, p. 5, Coffee 2006, pp. 296-297 and CGFS Report 2005, p. 15.
174 *See* Garciìa Alcubilla & Ruiz del Pozo 2012, p. 24. *Cf. Cf.* Simon 2017, pp. 59-61, the Financial Crisis Inquiry Report 2011, p. 150 and IOSCO Report 2008, p. 6.
175 Langohr & Langohr 2008, p. 185. Garciìa Alcubilla & Ruiz del Pozo 2012, p. 24, Gaillard 2010, p. 78 and IOSCO Report 2008, pp. 5-6.

structured finance products can be flexible,[176] but can raise concerns regarding, for example, the existence of conflicts of interests in comparison to the concerns raised regarding the rating process of traditional financial instruments.

3.3.3 Functions

The historical perspective on the credit rating industry and its civil liability revealed the two functions of credit ratings: providing information on creditworthiness to the financial markets and serving as a tool to comply with regulatory requirements.

The first function of credit ratings is to provide information on the creditworthiness of issuers and their financial instruments to the financial markets. This function can be traced back to the founding of the first credit reporting agencies: the need for independent reviews of creditworthiness of American merchants. Up to this day, the financial markets still need 'gatekeepers' or 'information intermediaries' who provide an indication of parties and projects that could be worth investing in, to the benefit of both issuers and investors.[177] Issuers use credit ratings to signal their creditworthiness to the financial markets and to attract funding, while investors can rely on credit ratings to distinguish the issuers and projects that suit their purposes best.[178] The facts that credit rating agencies qualify their credit ratings as 'opinions' only and the fact that credit ratings are not the only form of information intermediation investors can rely on, do not affect this main function of credit ratings in itself.

Overall, credit ratings are meant to reduce information asymmetries and can be said to thereby increase the transparency of the financial markets.[179] In the absence of proper alternatives, this information function causes credit ratings to be indispensable for the functioning of the financial markets. Without credit ratings or proper alternatives, investors must conduct their own creditworthiness assessments. Such internal, individual assessments are expensive and not manageable for smaller or inexperienced investors.[180] As a consequence, the overall funding costs would increase to compensate investors for

176 Garcìa Alcubilla & Ruiz del Pozo 2012, p. 24.

177 *See e.g.* Wimmer 2017, p. 42, Happ 2015, pp. 18-19, Schantz 2015, p. 67, Schroeter 2014, p. 51, Coffee 2013, pp. 84-85, Darbellay 2013, pp. 37-38 and Coffee 2006, p. 283. *Cf. also* Simmon 2017, p. 33.

178 *Cf.* Schroeter 2014, pp. 52-53 and Impact Assessment accompanying the Proposal for a Regulation on Credit Rating Agencies, COM(2008) 704 final, SEC(2008) 2745, p. 2. *Cf. also* IOSCO Report 2003, pp. 6-7.

179 Darbellay 2013, p. 38. *Cf.* Schroeter 2014, p. 51.

180 *Cf.* Darbellay 2013, pp. 38-39.

research costs and uncertainty. In the worst-case scenario, some investors will not invest at all, causing eligible projects and parties not to receive funding.

Furthermore, credit ratings serve as a tool for issuers and other parties to comply with regulatory requirements.[181] This function developed in the US, when the US legislature prohibited banks from investing in bonds lacking an investment grade rating[182] and the SEC introduced the 'NRSRO concept' (the Nationally Recognized Statistical Rating Organization concept).[183] Up to this day, legislation still refers to credit ratings so that the addressees of the legislation can use credit ratings to comply with certain regulatory requirements.[184] The use of credit ratings increased to such an extent that some scholars argued that credit ratings mainly fulfil a regulatory function rather than the function of information intermediaries.[185] In the aftermath of the global financial crisis, efforts have been made to reduce the importance of the regulatory function of credit ratings as the regulatory use was believed to have caused the overreliance on credit ratings and to have affected the quality of credit ratings. The Union legislature introduced rules to eliminate the use of credit ratings in financial regulation over time in the CRA Regulation.[186] However, reports of ESMA in 2014 have shown there are still many references to credit ratings in national and EU legislation[187] so that the regulatory function of credit ratings is still important. Examples of rating-based regulation can for instance still be found in the Basel III framework and in the European CRD IV framework,[188] under which credit ratings can be used to determine capital requirements for banks under the standardised approach (Art. 111 ff. CRR). More specifically, credit ratings can be used to determine the risk weight of an exposure under Article 135 (1) CRR which eventually determines how much capital the bank must hold against the exposure. However, also in respect of determining capital requirements, the European legislature has begun to exercise restraint in the use of credit ratings. For instance, Recital 70 and 71 of CRD IV state that '[o]wn funds requirements for credit risk and market

181 *E.g.* Wimmer 2017, p. 43.

182 Darbellay 2013, p. 20, White 2009, p. 2 and Coffee 2006, p. 289.

183 Darbellay 2013, p. 23.

184 *Cf.* Darbellay 2013, pp. 39-40, *see also* Garciìa Alcubilla & Ruiz del Pozo 2012, pp. 16 ff. and The Joint Forum 2009.

185 *See, on the different perspectives,* Coffee 2013, pp. 85-86 and Coffee 2006, pp. 288-289. *As stated by e.g.* Darbellay 2013, p. 27 and *cf.* Partnoy 2002, pp. 1-2, who stated that credit ratings have great market value but little informational value.

186 Art. 5a, 5b and 5c CRA Regulation.

187 European Securities and Markets Authority, *Technical Advice. On reducing sole and mechanistic reliance on external credit ratings*, 30 September 2015, ESMA/2015/1471, available at www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-1471_technical_advice_on_reducing_sole_and_mechanistic_reliance_on_external_credit_ratings.pdf, last accessed at 31 August 2019, p. 36.

188 CRD IV consists of the Capital Requirements Regulation 575/2013 (CRR) and the Capital Requirements Directive 2013/36 (CRD IV).

risk should be based on external credit ratings only to the extent necessary' because the former EU rules on capital requirements (Directives 2006/48/EC and 2006/49/EC) 'are one of the pillars upon which the overreliance on external credit ratings was built'. Therefore, according to the Union legislature, institutions should be encouraged 'to use internal ratings rather than external credit ratings'.

Finally, although being more a manner in which credit ratings are used rather than a function of credit ratings, parties make use of credit ratings in private law agreements, such as loan documentation.[189] Parties can draft agreements in such a manner that if a credit rating agency downgrades the credit rating of the borrower to a certain level (e.g. under AA), certain contractual terms are triggered. A downgrade can, for example, lead to a lender's right 'to terminate the credit availability, to accelerate credit obligations, or [to] have the borrower post collateral'.[190] Rating triggers aim to protect the lender, but can weaken the position of the borrower. Consider the situation in which the borrower is downgraded due to a liquidity crisis and, as a consequence of a rating trigger, must post more collateral.[191] Another way in which credit ratings are used by investors is in investment mandates. An investment mandate can involve the term that the assets shall not be invested in financial instruments of issuers rated below a certain level.[192]

3.3.4 Effects

3.3.4.1 Credit ratings, credit risk and investor compensation

Credit rating agencies are regarded as powerful players in the financial markets. Downgrades, and even warnings of potential future downgrades, of states and companies make the news on a regular basis.[193] This media attention stems from the potential consequences of downgrades. A downgrade suggests a decreased creditworthiness of the issuer. Investors can respond to a downgrade by demanding additional compensation for the increased risk affiliated with their investments, causing an issuer's funding costs to increase.

189 *E.g.* Schantz 2015, pp. 92 ff., Darbellay 2013, pp. 40-41 and Garciìa Alcubilla & Ruiz del Pozo 2012, p. 13.
190 Garciìa Alcubilla & Ruiz del Pozo 2012, p. 13.
191 Garciìa Alcubilla & Ruiz del Pozo 2012, p. 13. *Also* Schantz 2015, p. 93.
192 Schantz 2015, pp. 93-94.
193 *See e.g. in relation to Brexit,* The Guardian 'Moody's warns Brexit would risk UK's credit rating', 22 February 2016, available at www.theguardian.com/business/2016/feb/22/moodys-warns-on-brexit-risk-to-uk-credit-rating-eu-referendum, last accessed at 31 August 2019 and 'Brexit vote would affect UK's top credit score, says Standard & Poor's', 25 February 2016, available at www.theguardian.com/business/2016/feb/25/brexit-vote-would-affect-uks-top-credit-score-says-standard-and-poor, last accessed at 31 August 2019.

How can one explain the link between credit ratings and issuers' funding costs?[194] Credit rating agencies assess 'credit risk', i.e. the risk that the issuer will not fulfil its financial obligations in general or its financial obligations in respect of a particular fixed income financial instrument.[195] The underlying economic assumption is that the amount of credit risk determines the height of the compensation demanded by investors for the risks affiliated with their investments. The lower the credit rating, the higher the relative credit risk, and the more compensation investors demand for their investments in the form of higher coupon rates or higher yield.[196]

Credit ratings, rating changes and rating outlooks can influence amongst others coupon rates, current yield, credit spreads,[197] and prices of financial instruments. Empirical studies tend to measure such influence by analysing credit spreads and prices of financial instruments (mostly corporate, sovereign bonds and structured finance products). A multitude of empirical studies found evidence of some sort of influence of credit ratings on bond prices.[198] However, not all empirical studies point in the same direction and a few empirical studies have not found evidence of influence at all.[199] Furthermore, one must

194 This section only explains the link between credit ratings and issuer's funding costs in brief outline and from a factual perspective. A more detailed analysis of the empirical effects of credit ratings as well as of the economic reasons why credit rating agencies constitute these effects in light of the efficient market hypothesis falls outside the scope of this research.

195 IOSCO Report 2003, p. 3.

196 *Cf.* IOSCO Report 2003, p. 3. *Cf. also* Heiser 2019, p. 61, Gass 2014, p. 117, Nye 2014, p. 7 and Dalton 2008, p. 354. The 'coupon rate' is the fixed interest rate an issuer pays on a bond – in other words: 'the amount the bond pays out annually expressed as a percentage of the face value of the bond' (Dalton 2008, p. 152). For the sake of convenience, this dissertation refers to the term 'yield' only. However, one must realise that yield (or income) can be calculated in different manners. For instance, the 'current yield' is the expected average rate of return on a bond (or 'the total annual coupon income expressed as a percentage of the face value of the bond') and the 'yield to maturity' is the expected average rate of return for the duration of the bond (Dalton 2008, pp. 152-153).

197 The 'credit spread' is the difference between the yield of a specific bond and the yield of a benchmark risk-free bond, expressed in basis points. Dalton 2008, p. 351.

198 *See hereafter* section 3.3.4.2 for references to empirical studies.

199 This dissertation generally describes the main conclusions that can be drawn from these empirical studies. The exact (value of the) findings depends on the research method adopted, i.e. on the size and composition of the sample of newly issued credit ratings, credit rating changes or credit rating outlooks, the type of credit rating (attached to e.g. corporate bonds, structured finance products or states), the type of financial market (for e.g. corporate bonds, collateralised debt obligations or shares) and the geographical market (e.g. to the EU as a whole or to specific countries) to which the empirical study relates. Moreover, this section only reflects a small part of the empirical studies available in this field. For a more detailed analysis, reference is made to *e.g.* Schroeter 2014, pp. 60-71, Matthies 2013, pp. 6 ff. and Gaillard 2010, pp. 108 ff. *For another overview see also* Gass 2014, pp. 116 ff.

keep in mind that credit ratings and credit risk do not exclusively determine coupon rates, yield and prices of financial instruments.[200]

3.3.4.2 Empirical evidence bond and structured finance markets

(a) Primary markets

If an issuer issues bonds or structured finance products on the primary markets, the height of the credit rating determines the height of the coupon rate and yield.

Especially in structured finance markets, the height of the credit rating attached to the tranches is of crucial importance (see also section 3.3.2.3). The originator bundles the receivables in the SPV in order to ensure that the senior tranches receive a higher credit rating than the credit ratings of the separate receivables. This difference in the credit rating and corresponding coupon rate and yield make securitisation profitable for the originator: the coupon paid to the holders of the structured finance products is lower than the coupon received over the separate receivables.[201]

Compared to the influence of credit ratings on the secondary markets, there is less empirical evidence available on the influence of credit ratings on the primary bond markets.[202] Empirical research by Gabbi & Sironi in the field of Eurobond issues showed that 'the ratings of corporate bonds whether provided by Moodys' or Standard & Poors' are the most important factor determining the spreads between the yield to maturity of corporate bonds and that of equivalent Treasury securities'.[203] Hence, the height of the credit rating explained the difference (spread) in the return (yield) demanded by investors between the specific bonds measured and its benchmark bond. The height of the credit rating hence influenced the height of the issuer's funding costs.[204]

(b) Secondary markets

If a bond or a structured finance product is subsequently traded on the secondary market, a newly issued credit rating or a rating outlook or change can influence the price of the financial instrument. As empirical evidence discussed below showed, downgrades can cause the prices of financial instruments to move. The theoretical background of this causal relationship lies in the system of bond pricing. The financial markets determine the price or value of a bond

200 In pricing financial instruments, the financial markets do not only consider credit risk, but also e.g. supply and demand, maturity and interest rate risk. Nye 2014, p. 22. *See also* Dalton 2008, pp. 146-148, describing the influence of interest rates, creditworthiness and maturity.
201 *Cf.* Wood 2008, no. 28-14.
202 *See* Schroeter 2014, p. 60.
203 Gabbi & Sironi 2005, p. 72.
204 *Cf. also* Dalton 2008, p. 354.

by analysing 'the present value of all future cash payments made by the bond.'[205] If the financial markets conceive a downgrade to signal increased credit risk, investors wish additional compensation for the increased credit risk. To achieve increased compensation, the price of the bond decreases so that the yield increases and investors receive additional compensation. Hence, as rating downgrades suggest a relative deterioration of creditworthiness, the financial markets responded by requiring increased returns on downgraded bonds (so that bond prices decrease and yields and yield spreads increase).

The majority of the empirical studies on credit ratings concentrated on the influence of newly issued credit ratings and rating changes in the secondary bond markets.[206] Numerous empirical studies found evidence of the influence on bond prices and yields.[207] In a 2013 ECB Working Paper, for instance, Grothe found a significant reaction of the financial markets to downgrades: '[t]he specification differentiating between the direction of rating changes shows that the systematic and statistically reaction of spreads to rating changes is driven by downgrades.'[208] Grothe did not find a significant reaction to upgrades. Her empirical research also demonstrated that the magnitude of the reaction also depended on the economic state of the market.[209] As another example, in a 2011 ECB Working Paper, Afonso, Furceri & Gomes also found significant market responses of 'government rating yield bond spreads' and CDS spreads, especially in relation to negative announcements (downgrades or negative outlooks).[210] In contrast, some other empirical studies, mainly

205 Dalton 2008, p. 143. *Also* Heuser 2019, p. 61.
206 Schroeter 2014, p. 60.
207 *Cf. e.g.* Grothe 2013, pp. 14 and 17.
208 Grothe 2013, p. 14.
209 Grothe 2013, pp. 14-15 and 17.
210 Afonso, Furceri & Gomes 2011, pp. 20-21. *Cf. also in relation to the bond markets e.g.* May 2010, p. 2835: May found 'statistically significant abnormal bond returns' for both upgrades and downgrades in the two-day and the monthly bond returns; Kisgen & Strahan 2009, p. 24: Kisgen & Strahan investigated the influence of the NRSRO status of credit rating agency DBRS and found the bond yields decreased of entities to which DBRS had assigned a better credit rating than other credit rating agencies; Kliger & Sarig 2000, pp. 2881-2880: Kliger & Sarig found bond prices responded to amended credit ratings by Moody's in 1982 upon a refinement of their rating methods, while the issuers' risks had not changed substantially; Hand, Holthausen & Leftwich 1992, p. 734: Hand, Holthausen & Leftwich found significant responses to unexpected additions to Credit Watch Lists and significant responses to actual rating changes on both the bond and the equity markets. Furthermore, empirical studies were conducted as regards the influence of credit ratings on competitors, *e.g.* Caton & Goh 2003 (who only found significant results in relation to non-investment grade debt). *Cf. also in relation to the structured finance markets, e.g.* Micu, Remolona & Wooldridge 2004, p. 61: Micu, Remolona & Wooldridge demonstrated the influence of downgrades on credit default swap spreads, Hull, Predescu & White 2004, p. 2809 and Bedendo, Cathcart, El-Jahel & Evans 2013, p. 4. *See also* Schroeter 2014, p. 63. *See also* Micu, Remolona & Wooldridge 2006 on the influence of rating announcement on credit default swap spreads.

dating from the 1970s, did not find evidence of such reactions.[211]

As observed by Schroeter, one can draw some general conclusions from the empirical research, such as that downgrades cause stronger market reactions than upgrades[212] and that market reactions are the heaviest in relation to financial instruments and issuers rated on the border of investment/non-investment grade.[213] Furthermore, empirical studies showed that the more leveraged the rated entity is, the stronger the financial markets react to rating changes[214] and that the response of the financial markets is stronger in times of economic downturns.[215] Additionally, the empirical studies suggest that rating events preceding a downgrade[216] mitigate, but do not single out, the effects of downgrade on the financial markets.[217]

3.3.4.3 Empirical evidence from equity markets

The response to credit ratings is not limited to the bond and structured finance markets. Although credit rating agencies only rate issuers and financial instruments with a fixed income or debt obligatory nature, multiple empirical studies also found a relationship between rating changes and prices on the equity markets. Some studies concluded downgrades cause negative price reactions on the equity markets.[218] Yet, as pointed out by Goh & Ederington, the reason

211 *E.g.* Weinstein 1977, p. 345. *Cf. also* Gropp & Richards 2001, p. 5: Gropp & Richards did not find significant results, but they warn 'against concluding that ratings have little or no impact on bond prices and therefore, ratings may contain little or no informational value.'

212 Schroeter 2014, pp. 68-69. *Cf. e.g.* Grothe 2013, p. 17, Afonso, Furceri & Gomes 2011, pp. 20-21, May 2010, p. 2835 and Hand, Holthausen & Leftwich 1992, p. 744. *Cf. in relation to the structured finance markets* Micu, Remolona & Wooldridge 2004, p. 61.

213 Schroeter 2014, pp. 70-71 ff.

214 Kliger & Sarig 2000, p. 2881.

215 Grothe 2013, p. 17.

216 Such as credit rating outlooks and downgrades of credit ratings issued by other credit rating agencies.

217 *Cf. in relation to the structured finance markets* Micu, Remolona & Wooldridge 2004, pp. 61-62. *Furthermore, in relation to the influence of split-rated bonds* Cantor, Packer & Cole 1997, p. 15: Cantor, Packer & Cole found that, in case of 'split-rated' bonds by Moody's and Standard & Poor's, 'both ratings affect their yield'.

218 *E.g.* Labão, Pacheco & Campos 2018, p. 17, Abad-Romero & Robles-Fernández 2007, p. 102, Dichev & Piotroski 2001, p. 202, Barron, Clare & Thomas 1997, p. 508 and Hand, Holthausen & Leftwich 1992, p. 744. Some studies generally reported far less or no significant reactions to upgrades of credit ratings, other studies did suggest reactions to upgrades as well (Abad-Romero & Robles-Fernández 2007, p. 102 in relation to the Spanish equity market and Barron, Clare & Thomas 1997, p. 508 in relation to positive Credit Watch announcements on the UK equity market and Labão, Pacheco & Campos 2018, p. 17 in relation to credit ratings attached to European banks). *For a broad overview of the empirical findings,* Schroeter 2014, pp. 64-66. However, Kliger & Sarig 2000, p. 2881 found a positive price reaction of the equity markets on downgrades, which they explain by the 'asset-substitution theory'. According to Schroeter 2014, p. 64, fn. 46, these research outcomes however do not occur often. Furthermore, research of *e.g.* Bissoondoyal-Bheenick & Brooks 2015, p. 22, suggested changes of sovereign credit ratings influence equity markets as well.

why a credit rating agency decided to downgrade a credit rating determines the type of reaction of the equity markets. Goh & Ederington found evidence of the claim that equity markets respond negatively to downgrades 'due to a deterioration in the firm's financial prospects'.[219] But, whereas they expected bond prices to fall and equity prices to rise if 'the bonds are downgraded because the rating agencies foresee an increase in leverage that will transfer wealth from bondholders to stockholders', they did not find empirical evidence to support this expectation. Instead, they did not discover a reaction of the equity markets to such downgrades at all.[220] Overall, this research shows that care is needed when deriving general conclusions from rating changes, and the background of the change must be taken into consideration to determine the effects on the equity markets.[221]

3.4 EU REGULATORY FRAMEWORK

3.4.1 Objectives

In the aftermath of the global financial crisis, the Union legislature created a regulatory framework for credit rating agencies at the EU level.[222] This framework has a broad range of objectives. The first version of the CRA Regulation targeted the integrity, transparency, responsibility, governance and independence of the credit rating industry, so that the quality of credit ratings, the functioning of the internal market and the protection of consumers and investors is ensured.[223] The second and third versions broadened these objects, so as to promote credit rating agencies' independence, to increase the competition between credit rating agencies, to reduce the overreliance on credit ratings and to reduce (and eventually eliminate) the use of credit ratings for regulatory purposes.[224] The CRA Regulation consists of five titles which establish: rules on the subject matter, scope and definitions of the CRA Regulation (Title I); substantive rules on the issuing of credit ratings (Title II); rules on the supervision of credit rating agencies by ESMA (Title III); rules regarding the civil liability of credit rating agencies (Title IIIA); and, rules on the competences of ESMA with regard to the enforcement of the CRA Regulation (Title IV). Under Article 38a CRA Regulation, the European Commission can adopt delegated acts in relation to several elements of the CRA Regulation. In this

219 Goh & Ederington 1993, p. 2007. *See also for a description of these research outcomes* Schroeter 2014, p. 65.
220 Goh & Ederington 1993, pp. 2001 and 2007.
221 *Cf.* Goh & Ederington 1993, p. 2007. *See also* Gropp & Richards 2001, pp. 23-24, who explicitly confirmed the findings of Goh & Ederington.
222 *For detailed analyses of the European regulatory framework e.g.* Deipenbrock 2014.
223 Art. 1 CRA Regulation.
224 Recital 11, 9 and 8 CRA III Regulation, respectively.

section, a description will be provided of the most relevant aspects of the CRA Regulation for the purpose of this dissertation. The right to damages under Article 35a CRA Regulation is discussed separately in section 3.5.

3.4.2 Preliminary provisions

3.4.2.1 Scope of application

(a) Credit rating agencies registered in the EU

Pursuant to Article 2 (1) CRA Regulation, the CRA Regulation applies to credit ratings issued by credit rating agencies registered in the EU that are disclosed publicly or distributed by subscription.[225] The territorial scope of the CRA Regulation is hence limited, and the regulatory framework does not apply to credit ratings issued by the headquarters of Standard & Poor's and Moody's (established in the US).[226] The limited scope of the CRA Regulation is somewhat mitigated by the fact that the CRA Regulation encourages credit rating agencies to be established and registered in the EU.[227] Indeed, credit rating agencies should be established and registered in a Member State in order for their credit ratings to be allowed to be used for regulatory purposes by certain issuers (amongst others, credit institutions, investment firms and insurance undertakings).[228] As credit ratings are still used for regulatory purposes,[229] credit ratings of unregistered credit ratings agencies are rather useless to issuers so that issuers will not be prepared to pay for those credit ratings. In this way, the rules on registration encourage credit rating agencies to register themselves in the European Union and to become subject to the regulatory regime of the CRA Regulation.

In order to apply for registration under Article 14 (1) CRA Regulation, a credit rating agency must be 'a legal person established in the Community'. As explicitly stated by Recital 55 CRA I Regulation, credit rating agencies headquartered outside the EU must establish subsidiaries in the EU to be able

225 ESMA publishes a list of registered and certified rating agencies (available at www.esma.europa.eu/page/List-registered-and-certified-CRAs, last accessed at 31 August 2019).

226 *Cf. in respect of the civil liability regime under Art. 35a CRA Regulation* Steinrötter 2015, p. 111, Dutta 2014, pp. 34 and 40, Dutta 2013, pp. 1731-1732 and Gietzelt & Ungerer 2013, p. 339. *Contra* Lehmann 2016a, pp. 81-82, who argued the scope of the liability regime is unclear. *Cf. on the application of the CRA Regulation in general* Happ 2015, pp. 63-68 and Gass 2014, pp. 24-25.

227 *See* Dutta 2014, p. 34 and Dutta 2013, p. 1732.

228 Art. 4 (1) CRA Regulation. Pursuant to Art. 3 (1) (g) CRA Regulation, the term 'regulatory purposes' means 'the use of credit ratings for the specific purpose of complying with Union law, or with Union law as implemented by the national legislation of the Member States'. *See also* Moloney 2014, pp. 655-656.

229 On the regulatory function of credit ratings, section 3.3.3.

to apply for registration.[230] The subsidiaries can issue their own credit ratings or can endorse credit ratings of their parent companies.[231] As subsidiaries are fully responsible for both types of credit ratings,[232] the credit ratings of parent companies established in third countries are indirectly brought under the scope of the CRA Regulation.

(b) Credit rating agencies certified in the EU

As an alternative to registration, the CRA Regulation provides a credit rating agency established, registered and supervised in a third country the opportunity to apply for certification with ESMA.[233] Certified credit rating agencies can issue credit ratings that can be used for regulatory purposes in the EU without these credit rating agencies being physically present in the EU.[234] Certification is intended to be an exception for small credit rating agencies that are 'not systemically important for the financial stability or integrity of the financial markets of one or more Member States'.[235]

The question can be raised whether the liability regime under Article 35a CRA Regulation applies to certified credit rating agencies. Lehmann argues that '[i]t would make no sense to consider ratings that emanate from agencies in third countries as 'equivalent' to European ratings under Article 5 CRA Regulations, and then not subject them to civil liability under the same act.'[236] However, if one accepts that certification is based on equivalence, it is not that evident that the regime of Article 35a CRA Regulation should apply to certified credit rating agencies.[237] The idea behind certification is that physical presence (and registration) is not required because the legal and supervisory system of the third country can be considered equivalent to the CRA Regulation already, so that some sort of equivalent of Article 35a CRA Regulation could be assumed to exist.

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230 *See* Recital 55 CRA I Regulation. *See also* Dutta 2014, p. 34 and Dutta 2013, p. 1732. *Cf.* Gietzelt & Ungerer 2013, p. 339.

231 *Cf.* Art. 4 (3) CRA Regulation and *cf.* Lehmann 2015b, no. 444.

232 Under Art. 4 (4) CRA Regulation, an endorsed credit rating is considered to have been issued by the registered credit rating agency. Under Art. 4 (5) CRA Regulation, a registered credit rating agency will be fully and unconditionally responsible for an endorsed credit rating (*see also* Recital 18 CRA I Regulation). *See also* Gietzelt & Ungerer 2013, p. 339.

233 *See* Art. 5 (2) in conjunction with Art. 5 (1) CRA Regulation.

234 *Cf.* Recital 15 CRA I Regulation.

235 Recital 14 CRA I Regulation. At present, ESMA certified four credit ratings agencies, namely Japan Credit Rating Agency Ltd (Japan), Kroll Bond Rating Agency (US), HR Ratings de México, S.A. de C.V. (HR Ratings) (Mexico) and Egan-Jones Ratings Co. (EJR) (US), www.esma.europa.eu/page/List-registered-and-certified-CRAs/, last accessed at 31 August 2019.

236 Lehmann 2016a, p. 82.

237 *See* Dutta 2013, p. 1732. *Cf. also* Happ 2015, p. 67.

3.4.2.2 *Reducing overreliance*

An important objective of the third version of the CRA Regulation was to reduce the excessive reliance on credit ratings by financial markets and legislatures. To reduce the overreliance of market participants, Article 5a CRA Regulation prohibits so-called professional market participants, such as banks and insurers,[238] from solely or mechanistically relying on external credit ratings. Instead, they must carry out their own risk assessment, so that external credit ratings serve a complementary role. As will be discussed, this measure to reduce overreliance conflicts with Article 35a CRA Regulation, because Article 35a explicitly requires investors to provide evidence of their reasonable reliance on a particular credit rating.[239]

The Union legislature also tried to reduce the reliance on credit ratings by avoiding their regulatory use as much as possible. Under Article 5b, the European Supervisory Authorities (EBA, EIOPA and ESMA) shall not refer to or shall remove references to credit ratings in guidelines, recommendations and draft technical standards 'where such references have the potential to trigger sole or mechanistic reliance on credit ratings'. Sole and mechanistic reliance occurs 'when an action or omission is the consequence of any type of rule based on credit ratings (or credit rating outlooks) without any discretion', according to the European Supervisory Authorities.[240] It is, however, easier said than done to reduce the overreliance on credit ratings, especially because there are not always clear alternatives to using credit ratings.[241] In 2015, ESMA concluded: '[t]he process to reduce reliance on ratings in a European context can […] be said to be at an early stage'.[242]

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238 Under Art. 5a (1) in conjunction with Art. 4 (1) CRA Regulation, such entities are credit institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties.

239 Section 5.3.1.3 (c) (iii).

240 EBA, EIOPA & ESMA, *Final Report on Mechanistic references to credit ratings in the ESAs' guidelines and recommendations*, JC 2014 004, 6 February 2014, available at www.eba.europa.eu/documents/10180/534414/JC+2014+004+%28Final+Report+Mechanistic+References+to+Credit+Ratings%29.pdf/0262d0a1-dd1a-42af-ab4b-14cea710e876, p. 8, last accessed at 31 August 2019. The CRA Regulation does not involve a definition of 'sole and mechanistic reliance'.

241 *Cf.* Veil 2017, p. 567.

242 European Securities and Markets Authority, *Technical Advice. On reducing sole and mechanistic reliance on external credit ratings*, 30 September 2015, ESMA/2015/1471, available at www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-1471_technical_advice_on_reducing_sole_and_mechanistic_reliance_on_external_credit_ratings.pdf, last accessed at 31 August 2019, p. 36.

3.4.3 Substantive rules

Title II 'Issuing of credit ratings' established substantive rules on the issuing of credit ratings for credit rating agencies and for issuers, originators and sponsors[243] of structured finance instruments. The infringements listed in Annex III CRA Regulation are based on these substantive rules.

The CRA Regulation established stringent rules to guarantee the independence of credit rating agencies and their employees and to avoid conflicts of interests from arising under Articles 6-6b. It requires credit rating agencies to ensure 'effective internal control structure[s]' are in place to guarantee the independence of credit ratings, rating analysts and rating teams.[244] In addition, a party that holds 5% of the capital or voting rights of a credit rating agency is restricted in its involvement in other credit rating agencies.[245] Furthermore, Article 6b CRA Regulation addresses the independence in the relationships between credit rating agencies and structured finance issuers by introducing a mandatory rotation system. This mandatory rotation of credit rating agencies entails that '[w]here a credit rating agency enters into a contract for the issuing of credit ratings on re-securitisations, it shall not issue credit ratings on new re-securitisations with underlying assets from the same originator for a period exceeding four years'.[246]

Furthermore, the CRA Regulation created other rules to avoid conflicts of interest and to guarantee the quality of credit ratings. For instance, Article 7 CRA Regulation places credit rating agencies under the general obligation to ensure that 'rating analysts, its employees and any other natural person whose services are placed at its disposal or under its control and who are directly involved in credit rating activities have appropriate knowledge and experience for the duties assigned'. Also, rating analysts shall not be involved in negotiating a credit rating agency's fee and the compensation of a rating analyst shall not depend on the revenue that the credit rating agencies earns from rated entities.[247] In order to reduce chances of conflicts of interests and inflated credit ratings even further, Article 7 (4) requires credit rating agencies to introduce mandatory rotation systems for rating analysts.

243 Under Art. 3 (1) (v) CRA Regulation, a 'sponsor' means a sponsor as defined under Art. 4 (42) of Directive 2006/48/EC, i.e. a 'credit institution other than an originator credit institution that establishes and manages an asset backed commercial paper programme or other securitization scheme that purchases exposures from third party entities.' This definition can currently be found in Art. 4 (1) (14) CRR (Regulation (EU) No 575/2013).

244 Art. 6 (4) CRA Regulation.

245 Art. 6a CRA Regulation.

246 Under Art. 6b (5) CRA Regulation, the obligation of a mandatory rotation system does not apply to 'small' credit rating agencies that have fewer than 50 employees at group level involved in the provision of credit rating activities, or that have an annual turnover generated from credit rating activities of less than EUR 10 million at group level.

247 Art. 7 (2) and (5) CRA Regulation.

In addition, the CRA Regulation involves rules on credit rating methodologies and their disclosure under Article 8-8a. Credit rating agencies are for instance required to disclose their methodologies, models and key rating assumptions[248] to the public.[249] Also, rating analysts must assign credit ratings in accordance with these methodologies and, if they wish to deviate from the model, explain why they intend to do so.[250] Furthermore, credit rating agencies are under the obligation to properly monitor issued credit ratings.[251]

Finally, the CRA Regulation introduced specific requirements on the disclosure and presentation of credit ratings under Article 10-12. Specific presentation requirements apply, for instance, to the issue of structured finance ratings and sovereign ratings. The CRA Regulation requires credit rating agencies to state clearly that the credit rating is attached to a structured finance product or that the rated entity did not participate in the rating process by means of different colour codes for the rating category or by means of additional symbols.[252] As another obligation, if a credit rating agency decides to discontinue a certain credit rating, it has to disclose the reason for that decision.[253] Furthermore, credit rating agencies are subject to disclosure requirements on a general and periodic basis,[254] must submit information on their credit ratings and rating outlooks to ESMA for the purpose of the European Rating Platform (ERP)[255] and must publish transparency reports annually.[256]

3.4.4 Public enforcement by ESMA

The enforcement of the obligations created by the CRA Regulation is achieved through public enforcement by ESMA and through private enforcement by issuers and investors. The supervision of credit rating agencies was transferred from the national supervisors to ESMA in 2011 by the amendments of the second

248 Examples of key assumptions are mathematical, or correlation assumptions used.
249 Art. 8 (1) CRA Regulation.
250 Art. 8 (2a) and (4) CRA Regulation.
251 Art. 8 (5) CRA Regulation.
252 Art. 10 (3) and (5) CRA Regulation, respectively.
253 Art. 10 (1) CRA Regulation.
254 Art. 11 and Part I of Section E of Annex I CRA Regulation.
255 The ERP has been introduced by the third version of the CRA Regulation. The ERP is a central website on which ESMA gathers all credit ratings of an issuer or a financial instrument (under Recital 31 CRA III Regulation) that allows investors to easily compare those credit ratings. For additional requirements, see the Commission Delegated Regulation (EU) 2015/2 of 30 September 2014 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards for the presentation of the information that credit rating agencies make available to the European Securities and Markets Authority.
256 Art. 12 CRA Regulation.

version of the CRA Regulation. ESMA governs the registration procedure as established under Article 14-20 and has several supervisory powers under Article 21-35 to ensure credit rating agencies comply with the regulatory framework.[257] More specifically, ESMA's supervisory measures are linked to the infringements of Annex III. If ESMA concludes that one or more of the infringements listed in Annex III have been committed, the ESMA Board of Supervisors[258] can impose a fine under Article 23e (5) or, under Article 24 (1), can (1) withdraw the registration of the credit rating agency; (2) temporarily prohibit the credit rating agency from issuing credit ratings that have effect within the European Union; (3) suspend the use of credit ratings of the credit rating agency for regulatory purposes; (4) require the credit rating to bring the infringement to an end; or (5) issue a public notice. Credit rating agencies can appeal against these supervisory measures to the Board of Appeal[259] and, subsequently, can bring proceedings before the CJEU to contest the decision of the Board of Appeal.[260]

The powers of ESMA to impose fines and periodic penalty payments on credit rating agencies are worked out in detail under Title IV 'Penalties, fines, periodic penalty payments, committee procedure, delegated powers and reporting'.[261] Article 36a forms the 'public equivalent' of Article 35a. Under Article 36a, ESMA can impose fines for infringements of Annex III that have been committed intentionally or negligently[262] (in accordance with Art. 23e).[263] Under Article 36a (1), an infringement has been committed 'intentionally' when ESMA finds objective factors which demonstrate that the credit rating agency or *its senior management* acted deliberately. Under Article 36a (2), the height of the fine depends on the type of infringement that has been committed, on the annual turnover of the credit rating agency (also, the fine shall not exceed 20% of the annual turnover concerned in the preceding business year and, where the credit rating agency has directly or indirectly benefitted financially from the infringement, the fine shall be at least equal to that fi-

257 *See, more extensively,* Flinterman & Santella 2013, pp. 263 ff.

258 The voting members of the ESMA Board of Supervisors are the heads of the national competent authorities with regard to credit rating agencies (Art. 40 (1) (b) Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC) (hereafter: ESMA Regulation).

259 Art. 60 (1) ESMA Regulation.

260 Art. 61 (1) ESMA Regulation.

261 *Also* Commission Delegated Regulation (EU) No 946/2012 of 12 July 2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to rules of procedure on fines imposed to credit rating agencies by the European Securities and Markets Authority, including rules on the right of defence and temporal provisions.

262 The requirement of intention or negligence forms a lower threshold than required by Art. 35a CRA Regulation.

263 ESMA has imposed fines on e.g. Standard & Poor's (ESMA/2014/596) and DBRS Rating Ltd. (ESMA 2015/1050) both for internal control failings.

nancial benefit under Article 36a (4)) and on aggravating/mitigating factors listed in Annex IV. In addition, under Article 36b, ESMA can impose periodic penalty payments to compel the supervisory measures that ESMA can impose under Article 24 (1). Under Article 36d (1), both imposed fines and periodic penalty payments will be disclosed to the public unless such a disclosure would disproportionately damage the financial markets or parties involved. Article 36e explicitly stipulates that the CJEU has 'unlimited jurisdiction to review decisions whereby ESMA has imposed a fine or a periodic penalty payment'.

3.5 Private enforcement of Article 35a

3.5.1 Legislative history

3.5.1.1 Situation prior to Article 35a

Upon the introduction of the third version of the CRA Regulation, private enforcement began to complement the public enforcement of the CRA Regulation by ESMA. The civil liability of credit rating agencies, however, was already addressed in the first version of the CRA Regulation. Under Recital 69 CRA I Regulation, 'any claim against credit rating agencies in relation to any infringement of the provisions of this Regulation should be made in accordance with the applicable national law on civil liability'. Hence, EU law already prescribed the possibility of a right of redress for private parties in 2009. The French legislature acted upon this Recital by introducing special rules on the civil liability of credit rating agencies under Article L. 544-5 and L. 544-6 Code monétaire et financier.[264]

3.5.1.2 Public Consultation on Article 35a

The Public Consultation issued prior to the proposal for the third version of the CRA Regulation explicitly addressed the civil liability of credit rating agencies.[265] The respondents were divided on the desirability of introducing rules on civil liability at the EU level and the potential effects of such rules

264 *See* section 5.5.2.1 (a).
265 European Commission, Public Consultation on Credit Rating Agencies, 5 November 2011, pp. 24-25, available at http://ec.europa.eu/finance/consultations/2010/cra/docs/cpaper_en.pdf, last accessed at 31 August 2019. The Public Consultation closed at 7 January 2011, http://ec.europa.eu/finance/consultations/2010/cra/index_en.htm, last accessed at 31 August 2019.

on credit rating activities.[266] Moody's, Standard & Poor's, DBRS Ratings, the United Kingdom authorities (the FSA, HM Treasury and the Bank of England) and the Swedish Ministry of Finance, for instance, objected strongly to the idea of civil liability. Most importantly, it was argued that EU rules on civil liability (1) could lead to increased fees and could negatively affect the availability and quality of public ratings which could hamper market efficiency;[267] (2) could increase overreliance or could be contrary to the attempts to reduce overreliance on credit ratings;[268] (3) could weaken competition;[269] (4) would face many implementing issues;[270] (5) would not be as effective as financial sanctions;[271] and (6) would be unnecessary or undesirable as credit rating agencies were already subject to national general civil liability regimes.[272] Furthermore, it was emphasised that credit ratings are opinions about risks instead of guarantees of outcomes for which a credit rating agency should not be liable.[273] In contrast, other respondents did reply positively to the idea of civil liability in principle, although some respondents warned about the danger of negative consequences of civil liability as well.[274]

The different responses demonstrate the dilemma of introducing civil liability for credit rating agencies in general. On the one hand, one may wish to compensate issuers and investors who suffered loss as a consequence of misconduct committed by a credit rating agency. Such a wish can be rooted

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266 The responses are no longer available at the website of the European Commission. Therefore, reference is made only to the respondent and, if possible, the date of the response. This section does not reflect all responses to the Public Consultation.

267 *Cf. e.g.* Response Standard & Poor's, 12 January 2011, p. 13, Response Moody's, 7 January 2011, para 4.11, Response Swedish Ministry of Finance, 7 January 2011, p. 8, Response Association of British Insurers, January 2011, p. 3, Response BlackRock, 7 January 2011, p. 8, Response DBRS Ratings, 7 January 2011, pp. 7-8, Response European Association of Credit Rating Agencies, 7 January 2011, p. 5, Response German Insurance Association, 7 January 2011, p. 25 and Response Association Française des Trésoriers d'Entreprise, 7 January 2011, p. 6.

268 *Cf. e.g.* Response Standard & Poor's, 12 January 2011, p. 12, Response Swedish Ministry of Finance, 7 January 2011, p. 8 and Response BlackRock, 7 January 2011, p. 8.

269 *Cf. e.g.* Response Standard & Poor's, 12 January 2011, p. 14, Response Open Source Investor Service, p. 4 and Response BlackRock, 7 January 2011, p. 8.

270 *Cf. e.g.* Response United Kingdom authorities, p. 19, Response Swedish Ministry of Finance, 7 January 2011, p. 8, Response Wirtschaftskammer Österreich, 7 January 2011, p. 2.

271 *Cf. e.g.* Response Swedish Ministry of Finance, 7 January 2011, p. 8 and Response German Insurance Association, 7 January 2011, p. 2 and pp. 24-25.

272 *Cf. e.g.* Response German Insurance Association, 7 January 2011, p. 2 and pp. 24-25, Response European Association of Public Banks, 7 January 2011, p. 7 and Response Fitch Ratings, 6 January 2011, p. 4. Although, as Chapter 5 will show, this point of view does not apply to each Member State.

273 *Cf. e.g.* Response Fitch Ratings, 6 January 2011, p. 4.

274 *Cf. e.g.* Response AFG, 7 January 2011, p. 3, Response Association Française des Investisseurs Institutionnels, p. 9, Response Association of German Banks, p. 14, Response BDI, 7 January 2011, pp. 4-5, Response CFA Institute, 7 January 2011, p. 11, Response European Banking Federation, 7 January 2011, p. 13, Response EuroRating Services, 6 January 2011, p. 8 and Response RBS, 4 January 2011, p. 14.

in the possible preventive effects of civil liability threats or in motives of corrective justice. On the other hand, arranging for the civil liability of credit rating agencies involves serious challenges. Too far-reaching arrangements for civil liability may have negative effects on credit rating agencies and the financial markets as a whole. However, it is difficult to quantify the extent to which these potential negative effects could occur. It was hence up to the Union legislature to find a delicate balance between the interests of issuers, investors *and* credit rating agencies.

3.5.1.3 Impact Assessment

The Impact Assessment of the European Commission tipped the balance in favour of the introduction of stronger rules on the civil liability of credit rating agencies in 2011. The European Commission concluded that investors did not have a sufficient right of redress under the laws of the Member States. It stated that whether and, if so, under what conditions, investors could claim compensation varied 'largely' amongst the Member States. In Member States such as Sweden and Poland, civil liability claims based on infringements of the CRA Regulation were not even possible at all. Furthermore, national laws generally posed strict conditions to civil liability in the absence of a contractual relationship. These conditions were often vague and left to the discretion of national courts. According to the European Commission, the impression that investors do not have a sufficient right of redress was confirmed by the limited amount of case law available. The Impact Assessment concluded that this situation leads to different levels of investor protection and encourages forum shopping by credit rating agencies.[275]

Overall, the problem tree included in the Impact Assessment showed that investors did not have a sufficient right of redress due to a lack of civil liability regimes in some Member States (such as Sweden and Poland) and a risk of regulatory arbitrage (due to the large differences between the Member States). The lack of a sufficient right of redress was conceived to contribute to the more global problems of the credit rating industry: risks to market stability, low confidence in the financial markets, undermined investor confidence and undermined ratings quality.[276] The Impact Assessment concluded that action at the EU level was required in addition to public enforcement: 'The possibility of sanctioning CRAs is not a substitute for an efficient right of redress for investors. Sanctions imposed in the public interest do not compensate investors for their losses; a functioning sanctioning system and efficient right of redress for investors allowing for private enforcement are complementary instruments.'[277]

275 SEC(2011) 1354 final, pp. 18-19. *See also* SEC(2011) 1354 final, pp. 141-144.
276 SEC(2011) 1354 final, p. 10. *See also* SEC(2011) 1354 final, p. 23.
277 SEC(2011) 1354 final, p. 22. *Cf. also* Baumgartner 2015, pp. 498-500.

As already stated in section 2.5.4.2, the Impact Assessment investigated several options to ensure a right of redress for investors: (1) 'no policy change'; (2) 'introduce civil liability of CRAs into EU legislation'; and (3) 'ensure civil liability of CRAs towards users of credit ratings before national courts'.[278] Considering the problems indicated in the Impact Assessment, the first option was abandoned.[279] The Impact Assessment preferred the third option over the second option. Both options could ensure a sufficient right of redress, but the third option was less intrusive upon the Member States.[280] The principle of subsidiarity hence determined the choice in favour of the third option. Moreover, the Impact Assessment warned that the second option could 'increase the complexity of civil law systems of the Member States' if the sole topic of credit rating agency liability were regulated at the EU level.[281] The idea of the third option would 'set the principle and some conditions under which civil liability of CRAs should be possible'.[282]

3.5.1.4 EC Proposal & amendments

The Proposal of the European Commission resembled policy option 2 rather than policy option 3 of the Impact Assessment. The proposal of Article 35a CRA Regulation read:

> 'Article 35a – Civil liability
> 1. Where a credit rating agency has committed intentionally or with gross negligence any of the infringements listed in Annex III having an impact on a credit rating on which an investor has relied when purchasing a rated instrument, such an investor may bring an action against that credit rating agency for any damage caused to that investor.
> 2. An infringement shall be considered to have an impact on a credit rating if the credit rating that has been issued by the credit rating agency is different from the rating that would have been issued had the credit rating agency not committed that infringement.
> 3. A credit rating agency acts with gross negligence if it seriously neglects duties imposed upon it by this Regulation.
> 4. Where an investor establishes facts from which it may be inferred that a credit rating agency has committed any of the infringements listed in Annex III, it will be for the credit rating agency to prove that it has not committed that infringement or that that infringement did not have an impact on the issued credit rating.

278 SEC(2011) 1354 final, pp. 45-48. *See also* SEC(2011) 1354 final, pp. 150 and 156. The Impact Assessment and the Proposal of the European Commission initially introduced a right of redress for investors only. During the legislative proceedings, the right of redress was expanded to issuers as well.
279 SEC(2011) 1354 final, p. 46.
280 SEC(2011) 1354 final, pp. 46-47.
281 SEC(2011) 1354 final, p. 46.
282 SEC(2011) 1354 final, p. 47.

> 5. The civil liability referred to in paragraph 1 shall not be excluded or limited in advance by agreement. Any clause in such agreements excluding or limiting the civil liability in advance shall be deemed null and void.'[283]

The role of the applicable national law was described initially only in the proposed Recital 27: 'Regarding matters concerning the civil liability of a credit rating agency *and which are not covered by this regulation*, such matters should be governed by the applicable national law.'[284] An explicit reference to the applicable national law in the wording of Article 35a CRA Regulation was proposed by the European Parliament's rapporteur and was eventually adopted by the European Parliament.[285] Lehmann derived from these amendments that the final version of Article 35a CRA Regulation was a political compromise.[286] No one could object to the final version because, on the one hand, the civil liability of credit rating agencies was addressed at the European level, and, on the other hand, detailed harmonisation of national non-contractual liability law was avoided.

3.5.2 Conditions for civil liability[287]

The legislative proceedings described in the previous section resulted in a right of redress for issuers and investors, which is available in the presence and in the absence of a contractual relationship entered into with a credit rating agency.[288] Article 35a CRA Regulation serves two functions. First, the provision aims to compensate issuers and investors for loss caused by infringements of Annex III CRA Regulation.[289] Second, although not explicitly stated in the Recitals of the CRA III Regulation, it can be argued that Article 35a aims to prevent credit rating agencies from committing infringements ('*eine verhaltenssteuernde Funktion*'), thereby aiming to enhance the quality of credit ratings.[290]

283 COM(2011) 747 final, p. 33.
284 COM(2011) 747 final, p. 21. Emphasis added [DJV].
285 *See* A7-0221/2012, pp. 32 and 68 and P7_TA-PROV(2013)0012, respectively.
286 Lehmann 2016a, p. 78. *Also e.g.* Deipenbrock 2018, p. 561 and Haar 2014, p. 329.
287 This section briefly describes the conditions for civil liability under Art. 35a CRA Regulation. Section 5.3 discusses these conditions in detail, as they are the main thread running within the legal comparison.
288 *As stated explicitly by* Recital 32 CRA III Regulation.
289 *As can be derived from* Recital 32 CRA III Regulation. *E.g.* Heuser 2019, pp. 82-83.
290 *See e.g.* Heuser 2019, p. 83. Some scholars consider the preventive function of Art. 35a CRA Regulation to be most important. For instance, Lehmann argued that the compensation of private investors is not the main goal of Article 35a CRA Regulation. He emphasised that the CRA Regulation mainly wishes to prevent credit rating agencies from assigning incorrect credit ratings (Lehmann 2016a, p. 62). According to Berger & Ryborz, Art. 35a CRA Regulation does not only have a compensatory function. They attached more import-

Article 35a (1) CRA Regulation establishes five conditions for the civil liability of credit rating agencies:

1. A credit rating agency must have committed one of the infringements listed in Annex III CRA Regulation;
2. The infringement must have been committed intentionally or with gross negligence;
3. The infringement must have had an impact on the credit rating;
4. An issuer or investor must have suffered loss because of the infringement; and
5. With regard to an issuer: The infringement must not have been caused by misleading and inaccurate information provided by the issuer to the credit rating agency, directly or through information publicly available.
With regard to an investor: An investor must have reasonably relied on the credit rating in accordance with Article 5a (1) or otherwise with due care.[291]

In addition, Article 35a (3) CRA Regulation provides that credit rating agencies may not completely exclude their civil liability and may only limit their liability in advance as far as that limitation is reasonable and proportionate and allowed by the applicable national law in accordance with Article 35a (4) CRA Regulation.

Credit rating agencies, issuers and investors are the most important stakeholders that could be involved in legal proceedings based on Article 35a CRA Regulation.[292] The next section investigates the scope of application of Article 35a CRA Regulation by describing which credit rating agencies, issuers and investors could be involved in such legal proceedings.

3.5.3 Stakeholders defined and scope of application

3.5.3.1 'Credit rating agency'[293]

Article 35a CRA Regulation creates a right of redress against 'credit rating agencies' who committed infringements listed in Annex III CRA Regulation. The CRA Regulation defines credit rating agencies as legal persons 'whose occupation includes the issuing of credit ratings on a professional basis'.[294]

ance to the regulatory function of Art. 35a CRA Regulation (Berger & Ryborz 2018, p. 1236). *Also* Dutta 2013, p. 1732.

291 Recital 36 CRA III Regulation stipulates that the fact that certain categories of investors must make their own assessments of the creditworthiness of entities and financial instruments under Art. 5a (1) CRA Regulation, should not prevent courts from holding credit rating agencies liable. *See also on civil liability and overreliance e.g.* Lehmann 2016a, pp. 63-64.

292 Competitors of issuers who argue to have suffered loss by an infringement and an affected credit rating cannot base claims for damages on Art. 35a CRA Regulation.

293 *See for similar descriptions* Heuser 2019, pp. 88-90 and Wimmer 2017, pp. 87-94.

294 Art. 3 (1) (b) CRA Regulation.

The general scope of application of the CRA Regulation determines which credit rating agencies can be held liable under Article 35a CRA Regulation. As discussed in section 3.4.2.1 (a), the scope of application of the CRA Regulation is limited to credit ratings issued by credit rating agencies registered in the EU.[295] Article 35a CRA Regulation therefore only applies to such EU credit rating agencies and does not apply to the headquarters of Standard & Poor's and Moody's, located in the US.[296]

The consequences of the limited scope of the CRA Regulation are mitigated somewhat by the fact that the CRA Regulation encourages credit rating agencies to be established and registered in the EU.[297] Credit rating agencies must indeed be established and registered in a Member State in order for their credit ratings to be allowed to be used for regulatory purposes by certain issuers (amongst others, credit institutions, investment firms and insurance undertakings).[298] This way, the rules on registration encourage credit rating agencies to register themselves in the European Union and to become subject to the regulatory regime of the CRA Regulation.

In order to apply for registration, under Article 14 (1) CRA Regulation, a credit rating agency must be 'a legal person established in the Community'. As explicitly stated by Recital 55 CRA I Regulation, credit rating agencies headquartered outside the EU must establish subsidiaries in the EU in order to be able to apply for registration.[299] The subsidiaries can issue their own credit ratings or can endorse credit ratings of their parent companies.[300] As subsidiaries are fully responsible for both types of credit ratings,[301] the credit ratings of parent companies established in third countries are brought under the scope of the CRA Regulation.

295 ESMA publishes a list of registered and certified rating agencies (available at www.esma.europa.eu/page/List-registered-and-certified-CRAs, last accessed at 31 August 2019).

296 *Cf. in respect of the civil liability regime under Art. 35a CRA Regulation* Heuser 2019, pp. 90 and 93, Miglionico 2019, no. 9.04, Dumont du Voitel 2018, pp. 102-104, Wimmer 2017, p. 93, Schantz 2015, p. 356, Steinrötter 2015, p. 111, Dutta 2014, p. 40, Dutta 2013, pp. 1731-1732 and Gietzelt & Ungerer 2013, pp. 339-340. *Contra* Lehmann 2016a, pp. 81-82, who argued the scope of the liability regime is unclear, and Gass 2014, pp. 52-53. *See for the debate and arguments in favour of a broad scope of application of Art. 35a CRA Regulation* Wimmer 2017, pp. 87-89.

297 *See* Dutta 2014, p. 34 and Dutta 2013, p. 1732. *Also* Baumgartner 2015, p. 511.

298 Art. 4 (1) CRA Regulation. Pursuant to Art. 3 (1) (g) CRA Regulation, the term 'regulatory purposes' means 'the use of credit ratings for the specific purpose of complying with Union law, or with Union law as implemented by the national legislation of the Member States'. *See also* Moloney 2014, pp. 655-656.

299 *See* Recital 55 CRA I Regulation. *See also* Dutta 2014, p. 34 and Dutta 2013, p. 1732. *Cf.* Gietzelt & Ungerer 2013, p. 339.

300 *Cf.* Art. 4 (3) CRA Regulation and *cf.* Lehmann 2015b, no. 444.

301 Under Art. 4 (4) CRA Regulation, an endorsed credit rating is considered to have been issued by the registered credit rating agency. Under Art. 4 (5) CRA Regulation, a registered credit rating agency will be fully and unconditionally responsible for an endorsed credit rating (*see also* Recital 18 CRA I Regulation). *See also* Gietzelt & Ungerer 2013, p. 339.

Overall, issuers and investors can only bring claims for damages under Article 35a CRA Regulation against credit rating agencies established and registered in the EU and the scope of application of the civil liability regime is, therefore, limited.[302]

3.5.3.2 'Issuer'[303]

The CRA Regulation refers the term 'issuer' back to Article 2 (1) (h) Prospectus Directive.[304] Under this provision, an issuer 'means a legal entity which issues or proposes to issue securities'. It is remarkable that Article 35a CRA Regulation does not use the term 'rated entity', which 'means a legal person whose creditworthiness is explicitly or implicitly rated in the credit rating, whether or not it has solicited that credit rating and whether or not it has provided information for that credit rating'.[305] The term 'issuer' is too limited, because it is linked to the issue of 'securities' only and does not cover financial obligations such as loans.[306]

3.5.3.3 'Investor'

(a) Types of investors[307]

The CRA Regulation does not provide a definition of the term 'investor'.[308] This dissertation starts from the assumption that investor-claimants invested in fixed-income financial instruments or other types of debt, but Article 35a CRA Regulation does not exclude equity-shareholders as a matter of principle. Investors can involve both professional investors and retail investors.[309] Article 4 (1) (a) CRA Regulation provides examples of professional investors that can make use of credit ratings: credit institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties. Under Article 35a (2) and Article 5 (a (1) CRA Regulation, the civil liability of credit rating agencies towards these professional parties is limited. They must make their own assessments of the creditworthiness of issuers and are not allowed to

302 *For the same conclusion*, Heuser 2019, p. 89, Wimmer 2017, pp. 93-94 and Baumgartner 2015, pp. 511-512.
303 *See, for a similar type of description*, Wimmer 2017, pp. 86-87, Baumgartner 2015, pp. 521-522, Gass 2014, p. 58, Dutta 2013, p. 1730 and Gietzelt & Ungerer 2013, p. 340.
304 Art. 3 (1) (s) CRA Regulation.
305 Art. 3 (1) (f) CRA Regulation.
306 *Cf.* Heuser 2019, p. 104 who argues the term 'issuer' must therefore be interpreted broadly.
307 *See, for similar descriptions*, Heuser 2019, pp. 108-111, Wimmer 2017, pp. 84-86, Baumgartner 2015, pp. 517-521 and Gass 2014, pp. 58-61.
308 Heuser 2019, p. 108 and Baumgartner 2015, p. 517.
309 Wimmer 2017, p. 85 and Baumgartner 2015, p. 518.

'solely or mechanistically' rely on credit ratings in making their investment decisions. Furthermore, the term 'investor' does not only cover investors who decided to invest or continued to invest in the issuer, but also those investors who decided to disinvest in the issuer. This can be derived from the second sentence of Article 35a (1) CRA Regulation, which describes that investors must establish that they reasonably relied on a credit rating for a decision 'to invest into, hold onto or divest'.[310]

(b) Limitations from the investor-specific requirement

The second sentence of Article 35a (1) CRA Regulation stipulates that '[a]n investor may claim damages under this Article where it establishes that it has reasonably relied, in accordance with Article 5a(1) or otherwise with due care, on a credit rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating'. This investor-specific requirement suggests two further limitations to the scope of application of Article 35a (1) CRA Regulation in respect of investors. Yet, one can seriously doubt whether the Union legislature meant to limit the scope of application of Article 35a CRA Regulation, or whether the drafting of this investor-specific requirement was too imprecise.

First, the investor-specific requirement seems to limit the eligible investors to investors who invested in financial instruments of a fixed income or debt obligatory nature only. The second sentence of Article 35a (1) CRA Regulation indeed stipulates that an investor may claim damages 'for a decision to invest into, hold onto or divest *from a financial instrument* covered by that credit rating'.[311] This wording implies that only investors who invested into, held onto or divested from financial instruments with a fixed income nature are entitled to the right of redress under Article 35a CRA Regulation (because credit ratings do not cover other financial instruments). Consequently, equity investors cannot claim damages under this provision. But this wording also implies that investors who provide normal loans to issuers cannot claim damages under Article 35a CRA Regulation, if those debts do not qualify as financial instruments.[312] Whereas the limitation in respect of equity investors is imaginable, I doubt whether the Union legislature intended to limit the right of redress to investors who invested into, held onto or divested from financial instruments only.

Second, it can be questioned whether the second sentence of Article 35a (1) CRA Regulation limits the type of 'credit rating' that can trigger civil liability

310 Wimmer 2017, p. 86. *In more detail,* Heuser 2019, pp. 111-113.
311 Emphasis added [DJV].
312 Art. 3 (1) (k) CRA Regulation refers the term 'financial instrument' back to Section C of Annex I to Directive 2004/39/EC (MiFID I).

in respect of investors: financial instrument ratings only, or both financial instrument ratings and issuer ratings?[313]

Article 3 (1) (a) CRA Regulation defines a 'credit rating' as 'an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories'. The right of redress under Article 35a (1) CRA Regulation stipulates that '[w]here a credit rating agency has committed, intentionally or with gross negligence, any of the infringements listed in Annex III having an impact on a credit rating, an investor or issuer may claim damages from that credit rating agency for damage caused to it due to that infringement'. Both provisions do not indicate any limitation to the type of affected credit rating for which compensation can be claimed.

Nevertheless, German lower courts interpreted and applied this investor-specific requirement grammatically and thereby limited the scope of application of Article 35a CRA Regulation in another important, but possibly unforeseen, way.[314] The provision stipulates explicitly that an investor must reasonably rely on a credit rating 'for a decision to invest into, hold onto or divest from a financial instrument *covered by that credit rating*'.[315] This wording has led the German courts to restrict the scope of application of Article 35a (1) CRA Regulation. The German version of Article 35a (1) CRA Regulation states that '*[e]in Anleger kann nach diesem Artikel Schadenersatz verlangen, wenn er nachweist*, dass er sich bei seiner Entscheidung, in ein Finanzinstrument, auf das sich dieses Rating bezieht, *zu investieren, dieses Instrument weiter zu halten oder zu veräußern*'.[316] On the basis of this wording, German courts concluded that Article 35a (1) CRA Regulation does not apply to situations in which an investor invested on the basis of an issuer rating.

The local District Court Neuss adopted this restrictive approach to the application of Article 35a CRA Regulation in 2016. On the facts of the case, an investor provided a loan to a company on the basis of an allegedly incorrect BBB rating.[317] The investor claimed damages (amongst others) on the basis of Article 35a (1) CRA Regulation. The local District Court Neuss, however, held that Article 35a CRA Regulation did not apply to this situation:

> '*Die Vorschrift des Art. 35 a der Rating-VO ist jedoch auf den vorliegenden Fall nicht anwendbar. Unstreitig hat die Beklagte vorliegend ein Unternehmensrating erstellt. Zu*

313 *See, prior to the case law of the German courts on this question already,* Baumgartner 2015, pp. 519-520.
314 *On part of these German decisions also* Deipenbrock 2018, pp. 571-574.
315 Emphasis added [DJV].
316 Emphasis added [DJV].
317 Amtsgericht Neuss 28 December 2016, 80 C 3954/15, ECLI:DE:AGNE:2016:1228.80C3954.15.00, *BeckRS* 2016, 130332, paras. 2-5.

> *Recht führt die Beklagte aus, dass Art. 35 a der Ratingagentur-VO unterscheidet zwischen Ansprüchen des Anlegers und Ansprüchen des Emittenten. So kann ein Anleger dann Schadensersatz verlangen, wenn er nachweist, dass er sich bei seiner Entscheidung, in ein Finanzinstitut, auf das sich dieses Rating bezieht, zu investieren, dieses Institut weiter zu halten oder zu veräußern, vertretbarer Weise in Einklang mit Art. 5 a Abs. 1 oder sonstiger Weise mit gebührender Sorgfalt auf dieses Rating verlassen hat.* Erforderlich ist mithin ein Finanzinstrument, auf das sich das Rating bezieht. Ein Unternehmen selbst ist kein Finanzinstrument. *Dies ergibt sich insbesondere aus der Differenzierung zu den Ansprüchen eines Emittenten. Ein Emittent kann nach Art. 35 a Abs. 1 unter Abs. 3 Schadensersatz verlangen, wenn er nachweist, dass das Rating sich auf ihn oder seine Finanzinstrumente bezieht,* während ein Anleger ein solchen Anspruch nur hat, wenn sich das Rating auf ein Finanzinstrument bezieht, *was vorliegend unstreitig nicht der Fall ist, Aus dieser Unterscheidung zwischen den Anspruchsvoraussetzungen für einen Anleger und einen Emittenten folgt das vorliegend ein Anspruch aus Art. 35a Rating – VO 1060/2009 nicht gegeben ist. Hierfür spricht auch die Begriffsbestimmung von Finanzinstrumenten im Sinne des § 1 Abs. 11 KWG.*'[318]

Hence, the local District Court Neuss held that Article 35a CRA Regulation distinguishes between issuers and investors. Whereas issuers can bring a claim for damages relating both to issuer ratings and ratings attached to specific financial instruments, investors can only bring a claim for damages relating to ratings attached to specific financial instruments.

In subsequent proceedings, the Regional Court Düsseldorf and the Higher Regional Court of Düsseldorf followed the approach taken by the local District Court Neuss. In these proceedings, the claimant had invested in bonds issued by a certain company. The claimant argued that it based its investment decision on a solicited BBB rating attached to the company by the defendant.[319] Both in first and second instance, the German courts held that Article 35a (1) CRA Regulation did not apply. The Regional Court Düsseldorf repeated the reasoning of the local District Court Neuss. In addition, it stated that the wording of the provision is actually clear and that there is no room for a lenient application: '*[d]enn die Rating-VO hat diesbezüglich eine klare Differenzierung getroffen. Für eine dem klaren Wortlaut dieser Vorschrift widersprechende Auslegung, die ein ungleich höheres Haftungsrisiko für die Ratingagentur nach sich zöge, ist somit kein Raum.*'[320] The Higher Regional Court of Düsseldorf also held that there is clearly no room for a lenient application, on the basis of a grammatical, historical and teleological interpretation of Article 35a (1) CRA Regulation.[321]

318 Amtsgericht Neuss 28 December 2016, 80 C 3954/15, ECLI:DE:AGNE:2016:1228.80C3954.15.00, *BeckRS* 2016, 130332, para 23. Emphasis added [DJV].

319 Landgericht Düsseldorf 17 March 2017, 10 O 181/15, ECLI:DE:LGD:2017:0317.10O181.15.0A, paras. 3-5 and 7.

320 Landgericht Düsseldorf 17 March 2017, 10 O 181/15, ECLI:DE:LGD:2017:0317.10O181.15.0A, para 34.

321 Oberlandesgericht Düsseldorf 8 February 2018, I-6 U 50/17, ECLI:DE:OLGD:2018:0208.I6U50.17.00, *BeckRS* 2018, 2321, paras. 18-20.

The Higher Regional Court attached importance to the text of the Proposal of the European Commission, which created a right of redress for investors when a credit rating agency committed an infringement that impacted the credit rating 'on which an investor has relied when purchasing a rated instrument'.[322] It concluded that the scope of application qualifies as '*acte claire*' so that no preliminary questions needed to be asked to the CJEU.[323]

German scholars both applauded and criticised the restrictive approach of the German courts. On the one hand, Berger and Ryborz consider the wording of Article 35a (1) CRA Regulation to clearly involve a restriction to investments related to financial instruments only. Furthermore, they consider the restrictive approach to the civil liability of credit rating agencies in general justified, because of the important information function of credit ratings and the uncertainties associated with rating activities.[324] On the other hand, Arne Maier emphasised it is not certain that Article 35a CRA Regulation wishes to make a distinction between issuers and investors, especially because Recital 32 CRA III Regulation does not mention this distinction at all.[325] Heuser points to the fact that Article 5a (1) CRA Regulation – to which the investor-specific requirement of reasonable reliance under Article 35a (1) CRA Regulation refers explicitly – does not distinguish between issuer and financial instrument ratings.[326] Schroeter *inter alia* pointed to the unjustified distinction between issuers and investors resulting from the limitation to financial instrument ratings of the German courts.[327] Finally, Deipenbrock approached the restrictive German approach from a different perspective. He was of the opinion that the facts of these cases did not form a typical scenario of credit rating agency liability (because they concerned issuer ratings and not financial instrument ratings) and, therefore, that the relevance of these decisions is limited.[328]

The wording of Article 35a CRA Regulation does not excel in clarity. One can doubt whether the Union legislature actually meant to limit the right of redress to investors who invested in, held onto or divested from financial instruments in reliance on financial instrument ratings only. Such a restriction should then have already been addressed in the first sentence of Article 35a (1) CRA Regulation, or in the Recitals of the CRA III Regulation. Moreover, such a restriction seriously limits the scope of the right to damages under Article

322 Oberlandesgericht Düsseldorf 8 February 2018, I-6 U 50/17, ECLI:DE:OLGD:2018:0208.I6U50.17.00, *BeckRS* 2018, 2321, para 19, COM(2008) 704 final, p. 33.
323 Oberlandesgericht Düsseldorf 8 February 2018, I-6 U 50/17, ECLI:DE:OLGD:2018:0208.I6U50.17.00, *BeckRS* 2018, 2321, para 36.
324 Berger & Ryborz 2018, p. 1236.
325 See Landgericht Düsseldorf 17 March 2017, 10 O 181/15, ECLI:DE:LGD:2017:0317.10O181.15.0A, *VuR* 2017, pp. 383-387 annotated by R.A. Arne Maier, pp. 385-386 and Oberlandesgericht Düsseldorf 8 February 2018, I-6 U 50/17, ECLI:DE:OLGD:2018:0208.I6U50.17.00, *EWiR* 2018, pp. 273-274 annotated by R.A. Arne Maier, p. 274.
326 Heuser 2018, p. 83. *Cf. also* Schroeter 2018, p. 355.
327 Schroeter 2018, p. 355.
328 Deipenbrock 2018, p. 574.

35a CRA Regulation, as it rules out compensation in case of general investments in the issuer and investments in financial instruments based on issuer ratings. Especially in the case of smaller issuers, one could imagine these two situations occurring. Therefore, I do not agree with the Court of Appeal Düsseldorf that this issue can be considered an '*acte claire*', so that no preliminary questions needed to be asked to the CJEU.[329] The first part of Article 35a (1) CRA Regulation does not provide a restriction to financial instruments, and one can see no reason why the Union legislature intended to restrict the scope of application of Article 35a in this manner.

3.6 Factual perspective on credit rating agency liability

3.6.1 Four basic factual situations

The interpretation and application of Article 35a is strongly intertwined with the factual circumstances of concrete cases. Prior to the following Chapters on the Private International Law aspects of Article 35a CRA Regulation (Chapter 4) and the legal comparison (Chapter 5), it is, therefore, useful to provide a factual perspective on credit rating agency liability.

Chapters 4 and 5 are (implicitly[330]) based on four basic factual situations.[331] These situations can be distinguished from each other on the basis of the type of claimant involved (issuer or investor) and the type of relationship between the claimant and the credit rating agency (contractual or non-contractual):

1. An issuer brings a claim against a credit rating agency based on Article 35a CRA Regulation, while a contractual relationship (in the form of a rating contract for a solicited credit rating) exists between the credit rating agency and the issuer.
2. An issuer brings a claim against a credit rating agency based on Article 35a CRA Regulation, while no contractual relationship exists between the credit rating agency and the issuer. The dispute, hence, is about civil liability for the assignment of an unsolicited credit rating.

329 Oberlandesgericht Düsseldorf 8 February 2018, I-6 U 50/17, ECLI:DE:OLGD:2018:0208.I6U50.17.00, *BeckRS* 2018, 2321, para 36.

330 The distinction is not systematically made in Chapter 4, because, for Private International Law purposes, this dissertation considers claims based on Art. 35a CRA Regulation to be of a non-contractual nature (section 4.2). One should, however, always keep in mind whether contractual relationships between credit rating agencies and issuers or investors exist. Indeed, the fact that claims based on Art. 35a CRA Regulation are considered of a non-contractual nature for Private International Law purposes does not mean that existing contractual relationships between credit rating agencies and issuers or investors are not relevant for Private International Law purposes (as explained in section 4.2).

331 Deipenbrock 2018, p. 561. Deipenbrock also explicitly distinguishes between these four basic factual scenarios.

3. An investor brings a claim against a credit rating agency based on Article 35a CRA Regulation, while a contractual relationship (in the form of a subscription contract) exists between the credit rating agency and the investor.
4. An investor brings a claim against a credit rating agency based on Article 35a CRA Regulation, while no contractual relationship exists between the credit rating agency and the investor.

A multitude of different fact patterns can occur within these four basic factual situations. One of the most important variables is the capacity of the claimant. As touched upon in section 3.3.1, issuers can involve companies, financial institutions, states, municipalities, universities, hospitals etc. Investors can be institutional or professional investors, but they can also be retail investors. Furthermore, there are multiple ways in which affected credit ratings can cause loss to issuers and investors. Hereafter, sections 3.6.2 and 3.6.3 describe possible sequences of events leading up to loss suffered by issuers and investors, respectively.[332]

In advance, it must be remarked that the possible sequences of events have been oversimplified since the main purpose of these sections is to show how impacted credit ratings can cause loss and how credit ratings, coupon rates, yield and prices can interrelate. One should keep in mind, however, that credit ratings, and changes to credit ratings, do not necessarily influence prices of financial instruments traded on the financial markets.[333] Furthermore, one should keep in mind that the height of a credit rating is not the only factor that determines coupon rates, yield or prices of financial instruments. A multitude of other factors can influence these elements as well. Finally, one should keep in mind that the scenarios only involve the example of bonds traded on the financial markets. Yet, the broad mechanisms of the influence of credit ratings are similar for normal loans and other fixed-income financial instruments. All these caveats can cause the calculation of the effects of credit ratings and the loss suffered by issuers and investors to be very difficult.

3.6.2 Loss suffered by issuers

Issuers can claim to have suffered financial (pure economic) loss and/or reputational loss due to affected credit ratings.[334] The most likely line of argu-

332 *Cf. for similar descriptions of possible factual scenarios* Heuser 2019, pp. 62 ff., Baumgartner 2015, pp. 336 ff., Happ 2015, pp. 48 ff. and Gass 2014, pp. 61 ff.

333 For instance, market prices rather respond to downgrades than to upgrades (section 3.3.4.2). As pointed out by Heuser, market prices sometimes do not respond to credit rating(s) (changes) at all (Heuser 2019, p. 62).

334 Recital 32 CRA III Regulation implies that both types of loss fall under the scope of Art. 35a CRA Regulation by stating that it is important to provide issuers with a right of redress

ment put forward by issuers will involve that, one way or another, the issuer or its financial instruments ended up with a too negative credit rating. The credit rating can initially be too negative, or can be downgraded to a too negative rating category.[335] The issuer can argue that the too negative credit rating has caused reputational loss amongst customers and suppliers – which is difficult to calculate – or increased funding costs.[336]

How can a credit rating that is too negative lead to increased funding costs? As explained in section 3.3.4, the lower the credit rating, the more investors fear for the issuer's creditworthiness and the higher investors consider their credit risk to be, i.e. the risk that the issuer will not fulfil its obligations. Investors then demand a higher compensation for their investment, in the form of an increased coupon rate or a higher yield (return on their investment).[337] Hence, the issuer must pay a higher coupon rate on its financial obligations to its investors.[338] A credit rating that is downgraded to a too negative rating category can lead to increased funding costs in a similar manner. For instance, an issuer downgrade can cause the coupon rate on new financial obligations to increase.[339]

As an example of increased funding costs caused by a downgrade, reference can be made to the downgrades of ThyssenKrupp and its bonds by Standard & Poor's in 2003.[340] At the beginning of 2003, Standard & Poor's announced it would downgrade, and subsequently did downgrade, ThyssenKrupp from an investment grade credit rating to a non-investment grade credit rating and its bonds to a BB status. In a press release, ThyssenKrupp strongly criticised the decision of Standard & Poor's, stating that '[t]he facts concerning Thyssen-Krupp have not changed; the only thing that has changed is S&P's view of the way it assesses pension obligations'.[341] The downgrades were indeed a consequence of changes in Standard & Poor's rating model.[342] The financial markets nevertheless responded heavily to the downgrades; the downgraded

as an impacted credit rating 'can impact negatively the reputation and funding costs of an issuer.'

335 *E.g.* Gass 2014, p. 77 and Schroeter 2014, p. 791.

336 Heuser 2019, p. 63 and Gass 2014, p. 77.

337 *See e.g.* Heuser 2019, p. 63, Lehmann 2016a, p. 80, Dutta 2014, p. 35 and Dutta 2013, p. 1729. *Also* Dalton 2008, pp. 353-354.

338 Also, the value of the bond is lower, Dalton 2008, p. 146. *Cf. also* Gass 2014, p. 120.

339 *Cf.* Heuser 2019, p 64 and Gass 2014, p. 77.

340 *Example derived from* Schroeter 2014, pp. 85-86, Micu, Remolona & Wooldridge 2004, p. 55 and Empelmann 2007, pp. 177-178.

341 Press release of 21 February 2003, available at www.thyssenkrupp.com/en/newsroom/press-releases/standard---poor-s-downgrades-thyssenkrupp-two-notches-to-bb---loss-of-investment-grade-status-2221.html, last accessed at 31 August 2019.

342 Schroeter 2014, p. 85 and Empelmann 2007, p. 177.

bond price lost 8% of its value, while the share price lost 6% of its value.[343] Rough estimates of the increased funding costs diverged from EUR 20,000,000[344] to EUR 30,000,000.[345]

As credit rating agencies consult issuers when assigning a solicited credit rating – especially in relation to structured finance products – loss is most likely caused in relation to unsolicited credit ratings or announcements of downgrades, and subsequent downgrades. Furthermore, issuers can try to argue that a credit rating agency has failed to positively adjust an already existing credit rating in time, so that an issuer's credit rating remained too negative for an unnecessarily long time. However, gathering empirical evidence for this claim is difficult, especially if one considers that bond markets in general respond less to upgrades (see section 3.3.4).

3.6.3 Loss suffered by investors

When investors claim to have suffered pure economic loss[346] due to credit rating activities, a wider range of possible factual scenarios exists that could underlie such claims, in comparison to the case of issuers. These scenarios may often be of a complex factual nature.[347] If investors claim to have suffered loss due to credit rating activities, the loss is most likely to be caused by a too positive credit rating. This section concentrates on this situation only.[348]

343 *As derived from* Schroeter 2014, p. 86. *See also* Empelmann 2007, p. 178: Empelmann provided a chart of the spread in basis points of ThyssenKrupp's bonds. Subsequent to the announcement of the downgrades and the actual downgrades, the chart shows massive increases of the spread in basis points.

344 *As referred to by* Veil 2017, p. 552.

345 *As referred to by* Schroeter 2014, p. 86, fn. 187.

346 This dissertation employs the terms 'pure economic loss' and 'financial loss' interchangeably to describe the loss suffered by investors.

347 *Cf. also* Gass 2014, pp. 63 ff.

348 *Cf. also* Heuser 2019, pp. 65 ff., Baumgartner 2015, pp. 337-363, Happ 2015, p. 49 and Gass 2014, pp. 64-65. An investor can also purchase bonds to which a credit rating agency assigned a too negative credit rating. Let us assume the investor bought bonds on the primary market, to which (or to which' issuer) a too negative credit rating was assigned. A negative credit rating sends a negative signal of creditworthiness to the financial markets, so that investors demand a higher interest rate or yield or return on their investment. The inaccurate credit rating hence causes the investor to take less risk, while receiving a higher return. At the same time, one must realise the price of the bond will probably be too low (had the credit rating been higher, the interest rate would have been lower and the value of the bond would have been higher (Dalton 2008, p. 146)), so that the investor paid a too low price. If the investor decides to sell the bonds against the same price, it sold the bonds underneath their value. One can however doubt whether the investor suffered loss, if we assume that the investor initially paid this price for the bonds as well. Gass does consider the investor to have suffered loss, Gass 2014, pp. 66-67. *Also* Heuser 2019, pp. 65-66 and Baumgartner 2015, pp. 346-350. Furthermore, investors can suffer loss when the initially

Let us assume that an investor purchased bonds on the primary market, to which (or to the issuer of which[349]) a too positive credit rating was assigned. A positive credit rating sends a positive signal of creditworthiness to the financial markets, so that investors could demand a lower coupon rate or yield or return on their investment. The inaccurate credit rating, hence, may cause an investor to take more risk and to receive a lower return on its investment. At the same time, the price of the bond will probably be too high (had the credit rating been lower, the coupon rate would have been higher and the value of the bond would have been lower[350]), so that the investor paid an inflated price for the bond. Alternatively, let's say that an investor bought bonds on the secondary market, to which (or to the issuer of which[351]) a too positive credit rating was assigned. Assuming a causal relationship exists between the height of the credit rating and the bond price, a too positive credit rating can cause the bond price to be too high. The investor, hence, bought the bond for an inflated price and against a too low coupon rate.

In both scenarios, the investor possesses financial instruments that are in fact worth less than the inflated price paid for by the investor. Up to this point, it is not certain the loss will materialise. The investor will not suffer loss if it decides to sell the bonds prior to the discovery of the fact that the credit rating was too positive. But, say that the investor did not sell the bonds in time and it is discovered the credit rating is too positive. Say the credit rating is downgraded, and the bond price drops. The investor can then decide to sell the bonds against the lower price. But the investor might also possess bonds that have become completely worthless because the bond price has collapsed completely or because the issuer defaulted.[352] In hindsight, the investor can submit two factual lines of argument upon which to base its claim for damages:[353]

- Had the credit rating agency not assigned the too positive credit rating, the investor would have made a different investment decision. For instance, the investor would have invested in different financial instruments or would not have invested at all. The loss could then consist of the difference in value between the purchase price of the bond and the selling price of

assigned credit rating was accurate, but the credit rating agency subsequently inaccurately downgrades a credit rating or publishes an incorrect announcement of a downgrade. Say the credit rating is downgraded, and the price of the financial instruments drops. The investor will suffer loss if it decides to disinvest in the issuer and sells the bonds against the lower price.

349 Depending on how the scope of Art. 35a (1) CRA Regulation is defined, section 3.5.3.3 (b).

350 Dalton 2008, p. 146.

351 Depending on how the scope of Art. 35a (1) CRA Regulation is defined, section 3.5.3.3 (b).

352 *Cf.* Baumgartner 2015, p. 337.

353 *See also for these scenarios in the same context of the description of investors' loss,* Heuser 2019, p. 65.

the bonds (if we assume the investor has sold the bonds at that point) and missed potential benefits of an alternative investment.[354]
- Had the credit rating agency not assigned the too positive credit rating, the investor would have completed the transaction(s) against more beneficial terms, i.e. at a lower price and for a higher yield or against a higher coupon rate. The investor then in fact claims to have relied on the integrity of the financial markets. The loss could then consist of the difference in value between the purchase price of the bond and the real value of the bond and missed returns on the bond.

One must keep in mind that the scenarios and possible lines of argument described are oversimplified and face factual challenges in practice.

The scenario and the second line of argument are oversimplified where they assumed that there is a causal relationship between a credit rating, or a downgrade of a credit rating, and bond prices. First, it was assumed that the bond price drops subsequent to the downgrade, while the bond price might have shifted earlier in time. The downgrade was too little too late, and the financial markets could have already discovered and replied to the new findings on the creditworthiness of the issuer. Second, it assumed the downgrade was an isolated event, while the bond price can be affected by a multitude of different factors. In such situations, it can be difficult to isolate the effects of a credit rating from the effects of other events, such as a general economic crisis. Third, the scenario does not take into account the possibility that it is discovered far later that the credit rating has been affected by an infringement of Annex III CRA Regulation. Such an infringement is most likely to be revealed by sanctions imposed by ESMA. The causal link between a credit rating, or a downgrade of a credit rating, and bond prices thus exists in theory, but may be more difficult in practice.

Furthermore, the first line of argument was oversimplified in terms of causation by the fact that investors often do not base their investment decisions only on a single credit rating. A retail investor can decide to invest in the bonds after consulting several types of financial information – the prospectus, multiple credit ratings and reports, annual reports, recommendations of financial analysts etc. – or on the basis of advice from an investment advisor (or family and friends), or on the basis of portfolio restrictions (in the case of asset management). Professional investors can make their own analysis and can use credit ratings as an additional tool. Again, the causal link between a credit rating and an investment decision thus exists in theory, but may turn out to be difficult to establish in practice.

Overall, investors are mostly likely to claim loss allegedly caused by a too positive credit rating. The factual scenarios underlying such claims may be of a complex factual nature. The question that will also come up several times

354 Dutta 2014, p. 35 and Dutta 2013, p. 1729.

in subsequent chapters, is what loss is eligible – and should be eligible – for compensation.

3.7 Concluding remarks

This Chapter provided relevant background information on the credit rating industry and its history, credit ratings, the EU regulatory framework for credit rating agencies and the factual side of credit rating agency liability. Against this background, the other parts of this dissertation can be better understood.

The historical analysis provided in section 3.2 demonstrated that debates on the position of the credit rating agency industry and, in particular, on its civil liability have taken place since the establishment of the first credit reporting agencies in the mid-19th century. The storm of criticism credit rating agencies received in the aftermath of the recent financial crisis was not a new type of criticism, and, instead, a pattern throughout history can be identified. Despite the recurring commotion on the inaccuracy of credit ratings, credit rating agencies have faced very little civil liability threats throughout their existence. From this perspective, the introduction of Article 35a CRA Regulation was a breakthrough. It was also observed that since the period of economic recovery after 2015, the attention for credit rating agency liability seems to have somewhat decreased. When the research for this dissertation was completed, the credit rating industry had recovered from the financial crisis, the regulatory frameworks in the EU and US have been in place for several years and the fear that Article 35a CRA Regulation would open the floodgates for civil liability claims has turned out to be unjustified thus far.

Section 3.3 concentrated on credit ratings and, in particular, on their functions and effects. Credit ratings were described as opinions on the creditworthiness of fixed income financial instruments and issuers of such financial instruments.[355] They provide information on the relative chance that an investor will recover its investment from an issuer. The nature of credit rating activities renders it difficult to assess the accuracy of a particular credit rating, sometimes even in hindsight. The function of credit ratings is twofold: credit ratings provide the financial markets with information on the creditworthiness of issuers and financial instruments and serve as a tool for issuers to comply with regulatory requirements. These functions render credit ratings very important for the functioning of the financial markets. Although

355 Art. 3 (1) (a) CRA Regulation. Under Recital 8 CRA III Regulation, credit ratings are 'not mere' opinions. Credit rating agencies assign all different types of credit ratings, *cf. e.g.* Standard & Poor's rating definitions, available at www.standardandpoors.com//en_US/web/guest/article/-/view/sourceId/504352, last accessed at 31 August 2019 and Moody's rating definitions, available at www.moodys.com/sites/products/ProductAttachments/AP075378_1_1408_KI.pdf, last accessed at 31 August 2019.

credit ratings, and changes to these, do not always contain new information, empirical studies found that the financial markets nevertheless respond to credit ratings and changes to credit ratings, or announcements of changes. These effects were measured on bond markets, structured finance markets and even equity markets, demonstrating the importance the financial markets attach to credit ratings.

Section 3.4 described the regulatory framework for credit rating agencies under the CRA Regulation. The CRA Regulation has a limited scope of application, as it only applies to credit rating agencies registered and established within the EU. For its practical relevance, it is, therefore, important that the CRA Regulation encourages credit rating agencies to create and continue an establishment on EU territory by stipulating that credit ratings may only be used for EU regulatory purposes if the credit rating agency is registered and established within the EU. Nevertheless, one must realise that the CRA Regulation does not apply to the headquarters of Moody's and Standard & Poor's, which are situated in the US. Furthermore, it was discussed that the substantive rules under the CRA Regulation are subject to public and private enforcement. The emphasis lies on public enforcement by ESMA, which is complemented by the private right of redress for issuers and investors under Article 35a CRA Regulation.

As a prelude to Chapters 4 and 5, section 3.5 paid attention to the legislative history of Article 35a CRA Regulation and investigated the scope of application of Article 35a CRA Regulation by describing which credit rating agencies, issuers and investors could be involved in legal proceedings based on Article 35a CRA Regulation.[356] The analysis revealed that the scope of application of Article 35a CRA Regulation is limited in several respects. Issuers and investors can only bring claims for damages under Article 35a CRA Regulation against credit rating agencies established and registered in the EU, and not against the headquarters of Moody's and Standard & Poor's in the US. Furthermore, the strictly grammatical interpretation of the investor-specific requirement of reasonable reliance of the German lower courts severely limits the scope of application of Article 35a CRA Regulation, namely to investors who relied on a financial instrument for the decisions to invest, hold onto or divest from financial instruments only. Even though the first sentence of Article 35a (1) CRA Regulation, which creates the right of redress, does not provide for such restrictions, and one cannot see why the Union legislature would restrict the scope of application of Article 35a in this manner, the wording of the investor-specific requirement does not excel in clarity.

Finally, section 3.6 took a factual perspective on credit rating agency liability. The other parts of this dissertation, sometimes implicitly, take the four basic factual situations described as a starting point. As regards claims

356 Section 5.3 discusses the conditions for civil liability under Art. 35a CRA Regulation in detail in the context of the legal comparison.

for damages brought by issuers, this study makes a distinction on the basis of whether or not a contractual relationship exists between a credit rating agency and an issuer. In a similar manner, as regards claims for damages brought by investors, this study makes a distinction on the basis of whether or not a contractual relationship exists between a credit rating agency and an investor. One can design a multitude of different fact patterns in which affected credit ratings cause loss to issuers and investors. Issuers can suffer financial and reputational loss due to credit rating activities. Issuer claims can be based on the line of reasoning that, one way or another, the issuer or its financial instruments ended up with a too negative credit rating, which caused the issuer's funding costs to increase because investors fear for the issuer's creditworthiness and demand higher yields in return for their investments. Furthermore, investors can suffer financial loss due to credit rating activities. Investor claims can be based on the line of reasoning that, one way or another, the issuer or its financial instruments ended up with a too positive credit rating, which created an unjustified image of a certain level of creditworthiness so that an investor's investment decision was affected or the transaction was conducted against less beneficial terms for the investor.